

Australian Energy Market Commission

**Review of the Effectiveness of Competition in  
Electricity and Gas Retail Markets in Victoria**

First Final Report

19 December 2007

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## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. The AEMC's key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council on Energy as requested, or on AEMC initiative.

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## Foreword

The energy industry has been the subject of widespread reforms. At the start of the last decade, the industry was characterised by isolated state-based integrated monopoly businesses that were predominantly government-owned. The performance inefficiencies attributable to the monopoly structures and the absence of interconnection and effective competition prompted a joint government initiative to establish a dynamic, interconnected national energy market. The removal of barriers to interstate trade, efforts to harness competition and the introduction of incentive regulation were part of a wider goal to establish a single national energy market operating under a consistent regulatory framework.

A second wave of energy-specific reforms commenced in 2003. The Council of Australian Governments committed to the national governance, laws, rules and institutions to create an integrated national energy market framework. The reforms that stem from this commitment are focused on facilitating infrastructure investment, network interconnection and effective energy market competition.

The reviews being conducted by the Australian Energy Market Commission (Commission) of the effectiveness of retail competition in electricity and natural gas (gas) supply are a central plank of the policy strategy to improve energy market competition and efficiency. The outcomes of these reviews will directly influence policy decision-making on the future regulatory frameworks that will be applied to energy retailing in each jurisdiction, and particularly on the decisions regarding the need for retail price regulation in the future.

The first review, which focuses on energy retailing in Victoria (Victorian Review), has now reached an important milestone with the publication of this report. The Commission's finding that competition in electricity and gas retailing in Victoria is effective is an important step in the journey towards an integrated and competitive national energy market.

The Commission wishes to express its appreciation to the stakeholders who participated in the information gathering and consultation processes undertaken by the Commission leading to the publication of this report. By participating in these processes and providing written submissions, stakeholders have enabled the Commission to make findings and recommendations that are informed by stakeholder views and experience, relevant factual market information and rigorous, evidence-based analysis.

John Tamblyn  
Chairman  
for and on behalf of the  
Australian Energy Market Commission

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## Abbreviations and Glossary

2002 ESC Review	Review of the effectiveness of full retail competition for electricity, conducted by the ESC in 2002
2004 ESC Review	Review of the effectiveness of retail competition and consumer safety net in gas and electricity, conducted by the ESC in 2004
ACCC	Australian Competition and Consumer Commission
AEMA	Australian Energy Market Agreement
AEMC	see Commission
AER	Australian Energy Regulator
Commission	Australian Energy Market Commission
CAV	Consumer Affairs Victoria
Committee of Inquiry	Committee of Inquiry into the Financial Hardship of Energy Consumers
CRA	CRA International
CSM	Coal seam methane
EIA	<i>Electricity Industry Act 2000</i> (Vic)
ERA	Economic Regulation Authority (Western Australia)
ERIG	Energy Reform Implementation Group
ESC	Essential Services Commission (Victoria)
ESCOSA	Essential Services Commission of South Australia
EWOV	Energy and Water Ombudsman of Victoria
First Draft Report	<i>Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Draft Report</i> (October 2007)
First Final Report	<i>Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Final Report</i> (December 2007)
FRC	Full retail competition
FTA	<i>Fair Trading Act 1999</i> (Vic)
GIA	<i>Gas Industry Act 2001</i> (Vic)
Host retailer	A retailer that is also one of the three first tier retailers, being: AGL, Origin Energy and TRUenergy
Issues Paper	<i>Review of the Effectiveness of Competition in Gas and Electricity Markets – Issues Paper</i> (June 2007)
Marketing Code	<i>Code of Conduct for Marketing Retail Energy in Victoria</i> (October 2004)
MCE	Ministerial Council on Energy
MSO Rules	Market and System Operations Rules

MWh	Megawatt hours
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
NERA	NERA Economic Consulting
New retailer	A retailer that is not a host retailer
NMI	National Metering Identifier
PJ	Petajoule
Product Disclosure Guideline	<i>Guideline No. 19: Energy Product Disclosure</i> (December 2005)
PTS	Principal Transmission System
RoLR	Retailer of Last Resort
Second Draft Report	<i>Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – Second Draft Report</i> (December 2007)
Tier 1 Retailer	A retailer responsible under the EIA or GIA for the supply of electricity or gas (as appropriate) to franchise customers in the geographic supply area allocated to that retailer
Tier 2 Retailer	For a given geographic supply area, a retailer other than the first tier retailer
TIO	Telecommunications Industry Ombudsman
TJ	Terajoules
TPA	<i>Trade Practices Act 1974</i> (Cth)
VENCorp	Victoria Energy Networks Corporation
Wallis Consulting	Wallis Consulting Group Pty Ltd
Statement of Approach	<i>Review of the Effectiveness of Competition in Gas and Electricity Retail Markets – Statement of Approach</i> (April 2007)

## Executive Summary

Full retail competition (FRC) for Victorian electricity and gas domestic and small business customers commenced in 2002, and was accompanied by a price oversight mechanism and consumer protection arrangements to safeguard the interests of customers during the transition to effective competition. The objective of energy retail competition is to deliver efficient prices and services to energy customers and the opportunity for customers to exercise choice among competing retailers and their price and service offerings. Rivalry between retailers and the exercise of choice by customers maintains competitive pressure on retailers to manage their input costs effectively, to offer more cost-reflective prices and to improve and diversify the retail services they offer in order to better meet the preferences of customers. Together with competitive wholesale energy markets and efficient incentive regulation of energy network services, effective retail energy competition contributes to the efficient, reliable and secure energy supply needed by households and businesses. Affordable and secure energy supply underpins the future growth and development of the Australian economy.

Energy, particularly electricity, is an essential service for modern day living. Consumers expect reliable and secure energy supply and the energy market regulatory arrangements include obligations and incentives to that end. However, energy is also a homogeneous service which is treated as a relatively low involvement commodity by most energy consumers rather than a high value, differentiated product that justifies extensive market search and analysis. This consumer reality has an important influence on the development of the competitive environment for electricity and gas for both customers and retailers.

The Australian Energy Market Commission (Commission), in accordance with the terms of the Australian Energy Market Agreement (AEMA) and the request for advice from the Ministerial Council on Energy (MCE), is reviewing whether competition in electricity and gas retailing in Victoria is effective (Victorian Review). If competition is found to be effective, the Commission is required to provide advice to the Victorian Government and the MCE on ways to phase out retail price regulation.<sup>1</sup> Where competition is found not to be effective, the Commission's advice is required to identify ways to develop effective competition.

The Commission's finding is that competition in both electricity and gas retailing in Victoria is effective. The majority of energy customers are participating actively in the competitive market by exercising choice among available retailers as well as price and service offerings. There is strong rivalry between energy retailers, facilitated by the current market structures and entry conditions.

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<sup>1</sup> The Commission notes that while the AEMA and other documents relevant to the Victorian Review refer to "retail price regulation", the request for advice from the MCE notes (at footnote 1) that Victorian retail energy prices have not been regulated since 2002. Rather, the Government's oversight of retail electricity and gas prices comprises a sequence of six average annual adjustments agreed with host retailers for their domestic and small business customers, the last four years of which were the subject of a negotiated retail price path arrangement.



In reaching its conclusions, the Commission has considered whether the unique fuel-specific, production and trading characteristics of electricity and gas have a bearing on the effectiveness of competition in their respective markets. For example, electricity cannot be stored. It must be produced and consumed simultaneously using complex market arrangements to maintain the balance of supply and demand. Wholesale generation is delivered via networks. Although gas involves remote upstream production with the fuel delivered by pipeline networks, for consumers it is a largely discretionary fuel and competes in the longer term with other energy fuels, including electricity, for energy uses such as heating and cooling.

In this context, energy retailers perform a number of important functions. A retailer aggregates the demand of its individual customers and manages the price volatility of the energy it purchases on their behalf. Retailers also arrange for the delivery of energy via network access arrangements and by providing retail services such as customer billing and collection.

The Commission's finding that competition in electricity and gas retailing in Victoria is effective is supported by evidence of customer behaviour. Customers are demonstrating a clear willingness to participate in the competitive retail market if approached directly by a retailer. While customers may undertake only limited search activity on their own behalf, they respond well to direct marketing and exhibit a high willingness to switch retailers, particularly in response to lower prices. Neither brand loyalty nor perceived switching costs seem to be significant deterrents. Indeed, the percentage of all domestic and small business customers in Victoria who have entered into a market contract is currently 60 per cent for electricity and 59 per cent for gas. The Commission expects these levels of participation to increase further as competition continues to develop.

The Commission's finding that competition is effective is also supported by evidence of strong rivalry between retailers. Customers' lack of inherent engagement with basic energy products means that retailers have a strong incentive to be pro-active in seeking and retaining customers in competition with their rivals. There is evidence of vigorous marketing rivalry between retailers who are contacting customers directly, primarily through door-to-door sales and telemarketing. Consistent with the view that energy is a homogenous commodity, there is evidence that a large proportion of customers are unlikely to actively search for superior energy contract arrangements in the absence of such an active approach to marketing. Retailers are offering customers discounted tariffs together with a range of non-price incentives in an effort to differentiate their energy services from those of their rivals. For example, many retailers are offering accredited GreenPower or renewable energy products which appeal to customers. The Commission recognises the potential for direct marketing to involve misleading or deceptive conduct and/or high pressure sales techniques, which may in turn result in consumers making switching decisions which are not in their best interests. While relatively small in number, some consumer experiences and complaints have involved serious issues in this regard. This is not something which is unique to energy retailing and it requires an effective consumer protection framework to deter such conduct and to support the functioning of an effectively competitive market in which direct marketing can play a pro-competitive role facilitating consumer choice.

The current conditions for entry into and expansion within the retail energy sector are also positive. There has been substantial new entry into energy retailing in Victoria since the commencement of FRC, including from both established interstate retailers and “de novo” entry. The current market conditions encourage efficient entry, thereby creating a credible threat of competition from actual or potential new retailers and constraining the pricing and output decisions of existing retailers. Finally, overall, standing offer margins appear to have been largely sufficient to allow efficient entry and to allow retailers actively seeking customers to offer them price and non-price incentives. However, submissions from retailers in response to the First Draft Report highlighted one of the potential problems with regulated prices in this regard: as wholesale energy prices rose in 2007, at least one retailer temporarily ceased actively marketing retail energy contracts to customers because it was unable to profitably offer discounts from the standing offer tariff, which did not reflect the wholesale price rises.

The Commission recognises that there are legitimate concerns about those customers who, by virtue of their personal circumstances or the perception that they are unprofitable to serve, may not currently be able to access the full benefits of retail competition. The Victorian Government, in consultation with retailers and consumer groups, has developed and implemented a range of strategies to safeguard the interests of these customers. While it is important to distinguish hardship issues from competition issues and to recognise that price regulation is an inappropriate and blunt instrument to deal with the former, the Commission has the opportunity to provide targeted and practical advice to the Government regarding measures that would enable all classes of customers to experience the benefits of a superior competitive environment. For example, if the standing offer pricing arrangements were to be removed as part of the Government’s response to the Victorian Review, the Commission believes there may be merit in a process that includes retaining the obligations to supply for host retailers and a period of monitoring and reporting on standing offer pricing. These matters are discussed in greater detail in the Commission’s draft advice on ways to phase out retail price regulation to the Victorian Government and the MCE (Second Draft Report).

On the basis of the evidence and analysis contained in this report, the *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria* (First Final Report), the Commission’s conclusion is that competition in electricity and gas retailing in Victoria is effective. The Commission considers that competition is relatively more effective for electricity than for gas. Nonetheless, gas retailing is effectively competitive as retailers are pursuing opportunities to secure gas customers in conjunction with marketing electricity, the number of gas products available is continuing to grow and access to wholesale gas products is improving.

The Commission notes, however, that recent amendments to the rules governing the operation of the gas wholesale market could have unintended consequences for the future competitiveness of gas retailing in Victoria. The Commission understands that steps are being taken to address this concern and suggests that the effectiveness of this response be kept under review.

In light of its finding that competition is effective, the Commission is required to consider ways to phase out the current retail price regulation arrangements. This issue is addressed in the Commission’s Second Draft Report.

In the course of finalising its findings, the Commission has had regard to the views expressed by stakeholders on all aspects of its preliminary findings, including comments provided in submissions to the First Draft Report, and to other information gathered and analysis undertaken prior to the publication of the First Final Report.

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# 1 Introduction

## 1.1 Purpose of the First Final Report

The primary purpose of this report, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Final Report* (First Final Report), is to set out the Commission’s analysis and conclusions about the effectiveness of competition in the retail supply of electricity and gas in Victoria (Victorian Review). In summary, it details the Commission’s views about whether:

- competition in electricity retailing in Victoria is effective; and
- competition in gas retailing in Victoria is effective.

The Australian Energy Market Agreement (AEMA) requires the Commission to review the effectiveness of competition in the retail supply of electricity and gas in each jurisdiction participating in the NEM, and publicly report the results. The Victorian Review is the first such review, and the First Final Report sets out the Commission’s findings on the effectiveness of competition.

The Commission’s conclusions and the key evidence upon which its findings are based are summarised in Chapter 2. The detailed analysis underpinning the Commission’s conclusions is contained in Chapters 5 to 8 of the First Final Report.

## 1.2 Input from stakeholders

The Commission’s assessment of the effectiveness of retail competition directly influences the nature of the advice it will subsequently provide to the Victorian Government and the MCE concerning the future of retail price regulation. Given the significance of these recommendations, it is vital that the Commission test its analysis and conclusions through a process of open and informed public consultation.

To this end, the Commission invited public comment on the preliminary findings made in the *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria - First Draft Report* (First Draft Report) and the material supporting them. The Commission encouraged submissions to address these matters, and any other matter that was considered pertinent to the Commission’s analysis of the effectiveness of competition.

The Commission received 22 submissions from a range of stakeholders, including retailers, consumer groups and end use customers.<sup>2</sup> The Commission has published

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<sup>2</sup> Submissions were received from AGL Energy; Dr Kalissa Alexeyeff; Alternative Technology Association; Australian Power & Gas; Centre for Consumer and Credit Law (Griffith University); Minister for Energy, The Hon Patrick Conlon MP; Consumer Action Law Centre; Consumer Utilities Advocacy Centre; Energy Supply Association of Australia; Energy and Water Ombudsman (Victoria); Ms Madeleine Kingston (x2); Origin Energy; Public Interest Advocacy Centre; Red Energy; Simply Energy (x2); St Vincent de Paul; TRUenergy; Victoria Electricity; and Victorian Council of Social

each submission on its website, subject to claims for confidentiality. The Commission's approach to confidential information is explained in section 4.4 of the Statement of Approach.

### 1.3 Structure of the First Final Report

To assist stakeholders and interested parties, this section outlines the structure of the remainder of the First Final Report.

**Chapter 2** summarises the Commission's key findings on the effectiveness of competition in the retail supply of gas and electricity in Victoria, and identifies the primary evidence in support of the Commission's conclusions.

Chapters 3 and 4 provide the context for the Commission's review. **Chapter 3** sets out the policy and legislative framework for the Victorian Review, including the terms of reference provided by the MCE and the class of energy customers who are the focus of the Commission's analysis. This chapter also describes the analytical framework and methodology used by the Commission in undertaking the Victorian Review, including a summary of the information gathering and public consultation processes it has engaged in.

The history of full retail competition in Victoria is summarised in **Chapter 4**, including a brief overview of the industry restructuring that occurred prior to and following the introduction of FRC. It then provides factual background about the nature of energy retailing in Victoria, the demand and supply side characteristics of energy retailing in Victoria and some broad indicators of customer market participation. Chapter 4 also summarises the regulatory framework for retail price regulation in Victoria (i.e. the standing offer pricing arrangements) and certain other energy-specific regulatory interventions.

Chapters 5 to 8 contain the substantive information and analysis which underpins the Commission's findings in Chapter 2. The extent of rivalry between retailers is examined in **Chapter 5**. It considers the extent and nature of both price and non-price rivalry, the type of sales and marketing activities undertaken by retailers and whether sales and marketing efforts are being focused on, or away from, particular classes of customer and the reasons for any specific marketing conduct. The Commission's analysis also considers the prevalence of any mis-selling practices among retailers.

**Chapter 6** examines the customer experience of energy retailing in Victoria in order to assess the extent to which customers are informed and actively participating in energy retailing in ways that contribute to competitive pressure for retailers to base their price offers on their efficient costs and their service offers on the preferences of customers. It discusses customer experience of and participation in, energy retailing, including customers' willingness to actively seek out and respond to competitive offers. It also analyses the extent of customer switching and the reasons for it, and

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Services. The Commission also received two submissions from end use customers which, because the Commission was unable to verify that they consented to having their personal information published, were published under the name "End Use Customer 1" and "End Use Customer 2".

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the extent to which customers consider that they have access to and understand information about market offers. In examining these matters, Chapter 6 also summarises the results of the Commission's survey of domestic and small business customers.

**Chapter 7** focuses on the impact of entry conditions on competition, including the extent to which new entry or potential new entry constrains retailer behaviour. It identifies key structural conditions that govern energy retailing (including, for example, access to wholesale energy supply and risk management tools, economies of scale and scope) and analyses how these conditions affect the development of effective competition. Chapter 7 also assesses the impact of the existing regulatory structure on competition.

The Commission's observations about the margins that retailers are able to achieve under both standing offer and market contract prices are set out in **Chapter 8**. In considering these issues, the Commission has taken into account the costs faced by retailers and the relationship between the long-run efficient costs of supply and the prices charged to customers.

**Chapter 9** focuses on the experiences of specific classes of customers who may not be able to access the full benefits of retail energy competition in Victoria. These are customers who consume low volumes of energy, constitute an actual or potential credit risk (from a retailer's perspective), are experiencing financial hardship, or are otherwise disadvantaged in terms of their ability to participate in the competitive market (e.g. customers from non-English speaking backgrounds, the elderly or infirm, or those who have difficulty reading and writing).

**Chapter 10** outlines the immediate next steps for the Victorian Review, specifically the publication of the Commission's draft advice to the Victorian Government and the MCE on transitional measures.

Finally, the First Final Report includes **appendices** containing technical and other information relevant to the Commission's assessment of the effectiveness of competition. These appendices:

- provide basic factual information about each of the energy retailers that currently retail electricity and/or gas to domestic or small business customers in Victoria (Appendix A);
- contain a paper from LECG about the role of concentration ratios and market concentration indexes as a descriptive statistic for the purpose of competition analysis (Appendix B);
- summarise a selection of the electricity and gas market offers available in September 2007 to domestic or small business customers in Victoria (Appendix C);
- outline the obligations requiring retailers to provide information to customers (Appendix D); and
- provide a breakdown of the energy-related cases recorded by the Energy and Water Ombudsman (Victoria) during the 2006 calendar year (Appendix E).

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## **2 Findings**

As outlined in the Executive Summary, the objective of competition in energy retailing is to deliver efficient prices and services to customers and to give customers the opportunity to exercise choice among competing retailers and their price and service offerings. The purpose of this chapter is to summarise the Commission's findings arising from its assessment of the effectiveness of competition for the retail supply of electricity and gas in Victoria and to present the key evidence in support of its findings.

The Commission's finding is that competition is effective for both electricity and gas retailing in Victoria. The majority of energy customers are actively participating in the competitive market by exercising choice among available retailers and available price and service offerings. There is strong rivalry between energy retailers, facilitated by the current market structures and entry conditions. The Commission considers that competition is relatively more effective for electricity than for gas. Nonetheless, gas retailing is effectively competitive as retailers are pursuing opportunities to secure gas customers in conjunction with marketing electricity, the number of gas products available is continuing to grow and access to wholesale gas products is improving. The Commission notes, however, that recent amendments to the rules governing the operation of the wholesale gas market may have unintended consequences for the future competitiveness of gas retailing in Victoria. The Commission understands that steps are being taken to address this concern and suggests that the effectiveness of this response be kept under review.

### **2.1 Nature of demand for energy services**

The nature of demand for energy services has an important influence on the development of the competitive energy environment, and affects the roles that both customers and retailers play. As discussed in Chapter 4, energy is essential for modern day living and customers expect that it will be supplied reliably and securely. Notwithstanding its essential nature, a large proportion of customers consider energy is a low involvement commodity, meaning that the specific energy service they acquire and the retailer from whom they acquire it is of less importance. These features of demand can contribute to a perception on the part of many customers that the search and transaction costs associated with actively seeking out and acquiring the most suitable energy product outweigh the benefits of switching.

Customer attitudes towards energy prompt retailers to perform a number of important functions. Chiefly, it gives retailers a strong incentive to be pro-active in seeking and retaining customers in competition with their rivals by communicating the price and non-price advantages of their service offerings directly to customers.

The Commission considers that the nature of demand for energy services and the role that retailers play in procuring and supplying retail energy is reflected in the behavioural patterns of customers and retailers.

## 2.2 Retailer rivalry

The Commission's finding that competition in electricity and gas retailing in Victoria is effective is supported by evidence of strong rivalry between retailers as they compete to make offers to customers that are more attractive than those of their competitors. While effective competition requires both rivalrous conduct and informed and active customers making choices that best meet their wants or needs, retailer rivalry can also be an important determinant of customer participation in the market.

Consistent with the view that energy is a homogenous commodity, a representative survey of Victorian energy customers conducted by the Commission shows that many customers do not have a strong interest in their energy service arrangements and, in the absence of an active approach to marketing by retailers, are unlikely to be motivated to search for superior energy contract prices and conditions. Consequently, it is advantageous for retailers to actively seek out customers and communicate directly to them the price and non-price features of their energy offers.

The evidence shows that there is vigorous marketing rivalry between retailers who are contacting customers directly, primarily through door-to-door sales and telemarketing. Almost all market contracts being offered by retailers incorporate a price discount of some kind, regardless of consumption levels. The standing offer tariffs currently provide a focal point for both the level and structure of market offers which retailers use, in conjunction with pro-active marketing strategies, to attract new customers away from their existing retailer. Information gathered by the Commission indicates that the maximum discounts available under energy market contracts range from 2 to 10 per cent off the electricity standing offer tariff and 3 to 6 per cent off the gas standing offer tariff. A number of retailers are also offering accredited GreenPower or renewable energy products which appeal to customers.

The evidence before the Commission suggests that most retailers provide universal offers and, subject to limited exceptions (e.g. customers with confirmed poor credit histories or, in the case of gas, supply limitations), these offers are generally available to all customers. Further, the Commission has found no evidence to suggest that retailers are, or are able to, target their marketing efforts towards or away from individual customers based on the customer's propensity to switch or any other personal characteristic. There are indications, however, that high energy use customers who pay on time and in full are attractive to many retailers and marketing efforts may give priority, at least initially, to locations where households and small businesses best fit this profile.

The active marketing strategies implemented by retailers and the information they are providing is also helping to increase customers' interest in energy products, to better inform customers about their options and to overcome actual or perceived search and switching costs. To the extent that the majority of customers are responding to retailer contacts rather than incurring search and transaction costs to identify more favourable contract arrangements, this is likely to be a more efficient allocation of resources between customers and retailers.

If direct marketing is to facilitate consumer choice and competition, however, it must provide customers with accurate and useful information and not pressure consumers

into making decisions against their own best interests. The 2005-06 compliance monitoring report published by the Essential Services Commission (ESC) noted that there was a high level of compliance with regulatory obligations requiring information disclosure to customers.<sup>3</sup> However, the Commission's consumer survey indicated that there was still room for improvement in the quality and usefulness of the information that was provided, and data provided by the Energy and Water Ombudsman (Victoria) (EWOV) and other submissions indicates that one of the main causes for complaint against retailers, while not systemic, concerned the provision (or lack thereof) of information.

During this phase of the Victorian Review, the Commission was presented with anecdotal evidence and case studies of mis-selling and associated marketing practices such as high pressure selling or misleading or deceptive conduct. While the Commission has not been persuaded that mis-selling is systemic in energy retailing in Victoria, it does consider that it is incumbent upon energy retailers, in accordance with their licence conditions and requirements of the *Trade Practices Act 1974* (Cth) (TPA) and *Fair Trading Act 1999* (Vic) (FTA), to ensure their sales agents are not engaging in mis-selling or such other conduct that may mislead or deceive energy customers. There is a substantial regulatory framework in place to protect consumers from this type of activity but retailers need sufficient incentives to ensure that they are complying with that framework. This will depend on the likelihood of detection and the expected penalties. If a significant proportion of consumers do not complain, the expected penalties must be correspondingly higher. The Commission also considers that regulatory bodies such as the ESC and Consumer Affairs Victoria (CAV) have an important role to play in investigating allegations of non-compliance with consumer protection and licence obligations and, where necessary, taking appropriate steps to enforce compliance. Price regulation is not the appropriate policy to deal with issues relating to information disclosure, misleading or deceptive conduct or high pressure selling.

### 2.3 Customer participation

The Commission's findings in favour of the existence of effective retail competition are also supported by evidence of customer behaviour. Customers are demonstrating a clear willingness to participate in the competitive retail market if approached directly by a retailer. The Commission's research indicates that 94 per cent of domestic and small business electricity customers and 91 per cent of domestic and 95 per cent of small business gas customers are aware that they can choose their energy retailer. By the end of 2006, approximately 60 per cent of Victorian domestic and small business electricity customers and approximately 59 per cent of gas customers had entered into a market contract. Recent research indicates that this is the highest switching rate of any energy retail market in the world.<sup>4</sup> The Commission expects the current level of participation to increase as competition continues to develop.

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<sup>3</sup> Essential Services Commission, *2005-06 Compliance Report for Victorian Energy Retail Businesses*, February 2007, p. 11.

<sup>4</sup> First Data Utilities and VaasaETT Utility Customer Switching Research Project, *World Energy Retail Ranking*, 3<sup>rd</sup> edition, July 2007, p. 1.

The majority of domestic and small business customers have shown a willingness to participate in the competitive energy market and, while not generally initiating market search activity on their own behalf, are prepared to switch in response to the direct marketing initiatives of retailers, particularly in response to lower priced offers. This is consistent with the observations made above that many customers do not regard energy services as high value, differentiated products for which customer investment of time, effort and cost in market search activities are warranted. Notwithstanding this customer attitude to energy services, by the end of 2006, approximately 62 per cent of domestic and 43 per cent of small business electricity customers in Victoria had entered into a market contract. Of those customers with mains gas connected, approximately 60 per cent of domestic and 30 per cent of small business customers had switched to a gas market contract. Neither brand loyalty nor perceived switching costs appear to be significant deterrents to switching.

At the commencement of FRC, switching patterns reflected movements from the standing offer to a market contract offered by that host retailer. A growing number of customers are now switching between the market contracts offered by different retailers. The increasing rate of multiple switching suggests that customers do not appear to have experienced significant problems with the switching process. The evidence obtained by the Commission shows that most customers are satisfied with retail competition in terms of the price outcomes, the variety of offers available and the switching process. The evidence also indicates that a majority of the customers that have switched to or between market offers are satisfied that the new contract meets their expectations.

The high switching rates indicate that retailers are subject to a competitive discipline to develop and market attractive offers in order to retain their existing customers and to attract new customers. The Commission considers that the patterns of customer behaviour, together with the rivalry exhibited by retailers, are consistent with effective competition. Indications are that the competitive pressures in energy retailing in Victoria will continue and should also provide incentives for retailers to improve the features of their market offers to better meet customer preferences in the future.

## **2.4 Conditions for entry, expansion and exit**

Current conditions for entry into and expansion within the retail energy sector are also a positive influence on retail competition. They encourage efficient entry, thereby creating a credible threat of competition from actual or potential new retailers and constraining the pricing and output decisions of existing retailers.

There has been substantial new entry into energy retailing in Victoria since the commencement of FRC, including from established interstate retailers and “de novo” energy retailers. There is sufficient access to wholesale energy supply and related risk management instruments to enable new entrants to compete, although the liquidity of markets for risk management instruments is greater for electricity products than for gas.

Developments in technology and outsourcing have reduced the need to attain a significant “critical mass” to achieve profitable entry. New retailers are adopting

business models that embody more flexible approaches to managing costs and enable them to more easily realise the benefits of economies of scale, for example, through contracting out retailing services to specialist third party providers.

While host retailers may have inherited a significant customer base, low levels of brand loyalty and the willingness of customers to switch retailers when presented with an attractive offer have resulted in new and established retailers alike engaging in direct marketing, which is relatively scalable. New retailers are continuing to draw customers away from host retailers and the combined shares of all domestic and small business customers held by new retailers has increased steadily to 20 per cent for electricity and 12 per cent for gas.

The regulatory obligations that apply to energy retailers are, in large part, shared by all retailers. However, the scope and compliance costs of these obligations may affect potential entrants' willingness (or their perception of their ability) to commence efficient retail operations in Victoria. While the range of regulatory obligations evidently has some impact on retailer cost structures and would be a consideration for businesses contemplating retailing energy in the jurisdiction, the Commission notes that the effect has not been of such a magnitude as to deter either new entry or expansion. Furthermore, some level of licensing and prudential regulation is important for ensuring consumer confidence and willingness to participate in the competitive market.

Following the publication of the First Draft Report, the Commission became aware of the impact on gas retailers of recent changes to the manner in which liability for congestion uplift charges is determined under the MSO Rules. The effect of these changes, when coupled with the market demand and weather conditions experienced during winter 2007 in Victoria, resulted in congestion uplift charges being levied that, on some days, amounted to many millions of dollars. The information before the Commission suggests that the ability of retailers to obtain adequate hedges against uplift charges of this quantum will need to be addressed in order to ensure that there is no ongoing impediment to entry into and expansion within gas retailing in Victoria. The Commission understands that the implications for hedging arrangements was not clear at the time the amendments to the MSO Rules were made, and that VENCORP is working with market participants through the Gas Market Consultative Committee to develop a suitable solution to address this matter. The Commission suggests that this matter be kept under review.

On balance, current conditions for entry and expansion foster a credible threat of new entry, and significant entry has occurred, such that existing retailers are constrained in their price setting and output decisions. The Commission also notes that effective competition would be feasible in Victoria in the absence of the threat of entry, as long as sufficient rivalry continued between existing retailers for individual customers and for shares of the total number of customers.

## **2.5 Profit margins**

One of the outcomes of effective competition is that there is pressure for prices to converge towards efficient costs over time. This implies that retail profit margins

under market contract prices should be consistent with a competitive return for risk and financing costs.

The Commission engaged CRA International (CRA) to provide quantitative analysis on energy retail margins in Victoria as a basis of assessing whether the margins available under market contract prices are consistent with the expectation of margins in a competitive market. CRA's results suggest that competition has placed sufficient pressure on retailers' market offer prices to maintain margins at levels that would be expected in a competitive market.

The Commission asked CRA to examine the margins that are available under the current standing offer tariffs to assess the impact retail price regulation may have had on entry and competition. For example, a low margin under the standing offer tariffs may itself be a barrier to effective competition. CRA's results suggest that, for electricity, the level of the current standing offer tariffs have not prevented efficient new entry from being profitable, at least when considered on average across all customers in a distributor's service area. However, the results indicate that the scope to offer discounts off the standing offer price for gas for some customers may be limited.

Overall, retailers actively seeking new customers and growth in the proportion of the total customers they serve appear to be able to earn sufficient margins to offer attractive price and non-price incentives relative to the standing offer tariff. However, the Commission is mindful that a reasonable margin for the average customer does not mean that all customers are necessarily profitable under the standing offer tariff. Furthermore, the potential impact of price regulation in deterring competition was observed during 2007 when rising wholesale prices, coupled with regulated standing offer price, resulted in at least one retailer withdrawing from actively marketing energy contracts to customers, because it could not do so profitably at prices which were attractive compared to the standing offer.

## **2.6 Equitable access to the benefits of competition**

Given the Commission's finding that competition is effective, the AEMA requires that the Commission consider ways to phase out the current retail price regulation arrangements. However, the Commission recognises that there are legitimate concerns about those customers who, by virtue of their personal circumstances or the perception that they are unprofitable to serve, may not currently be able to access the full benefits of retail competition. This issue will be further addressed in the Commission's advice to the Victorian Government and the MCE as part of the second phase of the Victorian Review, in light of the Commission's findings on the effectiveness of energy retail competition in Victoria.

It is important to clearly distinguish issues relating to competition and issues relating to hardship and to address each with appropriately targeted policies. The Commission notes that the Victorian Government, in consultation with retailers and consumer groups, has developed and implemented a range of measures to safeguard the interests of customers experiencing hardship. In the next stage of the Victorian Review, the Commission has the opportunity to provide targeted and practical advice to the Government regarding measures that would enable all classes of

customers to experience the benefits of a superior competitive environment. For example, if the standing offer pricing arrangements were to be removed as part of the Government's response to the Victorian Review, the Commission believes there may be merit in a process that includes retaining the obligations to offer a supply for host retailers and a period of monitoring and reporting on market contract pricing.

## **2.7 Second Draft Report**

The publication of the First Final Report concludes the first phase of the Victorian Review, that is, the Commission's assessment of the effectiveness of competition in electricity and gas retailing in Victoria. The second and final stage of the Review is to advise the Victorian Government and the MCE on ways to phase out retail price regulation. The Commission's draft advice, which is the subject of the Second Draft Report, will be published on the Commission's website concurrently with the First Final Report.

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### 3 Commission's Framework for Analysis

This chapter summarises the analytical and methodological approach used in the Victorian Review. It begins by describing the policy that underlies the Victorian Review, and summarising the terms of reference that apply to the Review. It then outlines the general analytical framework used by the Commission to assess whether competition is effective, which is the framework the Commission has applied in its analysis of the matters contained in Chapters 5 to 8 of the First Final Report. This chapter concludes by setting out the information gathering and public consultation processes undertaken during this stage of the Victorian Review.

#### 3.1 Policy and legislative framework

The ongoing energy market reforms continue to introduce important changes to the structure and operation of Australian energy markets. The commitment of the Commonwealth and the States and Territories to these reforms is reflected in the terms of the AEMA. One of the commitments made by each of the signatories is to review the effectiveness of competition in the retail markets for electricity and gas for the purpose of retaining, removing or reintroducing retail price regulation.<sup>5</sup>

The AEMA requires the Commission to review and publicly report on the effectiveness of competition in the retail energy markets of the jurisdictions that are signatories to the AEMA (retail competition reviews).<sup>6</sup> Where competition is found to be effective, the Commission is to provide advice on ways to phase out retail price regulation. Where competition is found not to be effective, the Commission's advice must suggest ways to improve competition.<sup>7</sup>

On 19 April 2007, the MCE advised the Commission that the retail competition reviews would be conducted sequentially, confirming that the first jurisdiction to be reviewed would be Victoria.<sup>8</sup>

In conducting each review, the Commission is required to follow the framework provided for in clauses 14.10 to 14.16 of the AEMA. This requires, amongst other things, the Commission to base its assessment of the effectiveness of competition on

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<sup>5</sup> Clause 14.11(a), AEMA.

<sup>6</sup> The functions and powers conferred on the Commission by clauses 14.11, 14.14 and 14.15 are conferred upon the Economic Regulation Authority (ERA) of Western Australia, who is required to undertake the review for its jurisdiction at an appropriate time. As the Northern Territory does not have reticulated natural gas and full retail competition for electricity customers is not expected by 1 April 2010, it is not yet scheduled to participate in the retail competition reviews.

<sup>7</sup> The framework for the retail competition reviews is prescribed in clauses 14.10 to 14.16 of the AEMA.

<sup>8</sup> Letter dated 19 April 2007 from the Chair of the MCE, the Hon Ian Macfarlane MP to Dr John Tamblyn, Chairman of the Australian Energy Market Commission.

criteria developed by the MCE in consultation with the Commission and other interested parties (MCE criteria).<sup>9</sup> The MCE criteria are:

- independent rivalry within the market;
- the ability of suppliers to enter the market;
- the exercise of market choice by customers;
- differentiated products and services;
- price and profit margins; and
- customer switching behaviour.

On 25 May 2007, the MCE formally requested the Commission to provide advice on the state of competition in, and retail price oversight for, electricity and natural gas retailing in Victoria (Request for Advice).<sup>10</sup> Consistent with clauses 14.10 to 14.16 of the AEMA, the Request for Advice requires the Commission to apply the MCE criteria in providing its advice.

The Request for Advice also requires the Commission to use the methodology and approach detailed in Parts 2 and 3 of the Statement of Approach.<sup>11</sup> The Statement of Approach outlines the Commission's proposed approach to conducting the retail competition reviews, including the method of applying the MCE criteria and the Commission's consultation process. The Commission provided the Statement of Approach to the MCE on 19 April 2007.

Neither the AEMA nor the Request for Advice define the scope of the Victorian Review. Through correspondence to the MCE and the Statement of Approach, the Commission established that the focus of the Victorian Review is "domestic and small business customers" namely, customers who consume 160MWh or less of electricity per annum or who consume 5TJ or less of gas per annum, as consumption below these thresholds is subject to retail price oversight.<sup>12</sup> Accordingly, the Commission's role in the Victorian Review is to assess whether competition is effective for domestic and small business customers.

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<sup>9</sup> Clause 14.11(a)(i), AEMA.

<sup>10</sup> The Request for Advice can be downloaded from the Commission's website at [www.aemc.gov.au](http://www.aemc.gov.au).

<sup>11</sup> The Statement of Approach can be downloaded from the Commission's website at [www.aemc.gov.au](http://www.aemc.gov.au).

<sup>12</sup> The Order in Council made under s 35 of the EIA (dated 11 January 2002 and gazetted in Victorian Government Gazette No. S 11, 11 January 2002) and the Order in Council made under s 42 of the GIA (dated 29 October 2002 and gazetted in Victorian Government Gazette No. S 197, 29 October 2002) provides that the exercise of the Victorian Government's reserve power to regulate electricity and gas retail tariffs shall apply to "domestic or small business customers", i.e. those customers who consume 160MWh or less of electricity per annum or who consume 5TJ or less of gas per annum. For consistency, the Commission has adopted this term for the purpose of the Victorian Review.

The Commission formally commenced the Victorian Review on 1 June 2007 by releasing an Issues Paper calling for comment from interested parties on a number of matters relating to retail energy competition and the experiences of energy customers specific to Victoria. Submissions were required by 29 June 2007.

On 4 October 2007, the Commission published a draft report, setting out its preliminary findings arising from its assessment of the effectiveness of competition in electricity and gas retailing in Victoria.<sup>13</sup> Interested parties were invited to make submissions by 9 November 2007.

## **3.2 Commission's framework for assessment**

The central notion underpinning the Victorian Review, and each of the subsequent retail competition reviews, is the concept of competition and the circumstances in which competition is considered to be effective. Before the Commission is able to assess whether competition is effective, it must first delineate these concepts. Having done so, the Commission can then develop and implement a framework for analysing whether there is effective competition in gas and electricity retailing in Victoria.

The Commission's views about what constitutes "effective competition" are set out in detail in Chapter 3 of the Statement of Approach. Given the centrality of the concept of effective competition to the Victorian Review, the Commission has included a summary of its views in this section.

This section also outlines the analytical framework that has guided the Commission's assessment of the effectiveness of competition in electricity and gas retailing in Victoria. The framework integrates three key strands of analysis identified by the Commission as central to an assessment of effective competition, and a number of specific indicators within each strand. The Commission has considered how these strands and indicators relate to one another, and how they combine to underpin the effectiveness of the competitive process.

### **3.2.1 "Effective competition"**

Competition is a process of rivalry between sellers to win the business of customers (or between buyers to obtain supplies). Firms supplying in competitive markets attempt to improve their offers to consumers – in terms of prices, products and service delivery – relative to other firms in the market. Competition implies independence of action and the absence of collusion or coordination between suppliers. Each market participant is constrained in its price and output decisions by the market activity and competitive responses of rival businesses. The exercise of informed customer choice among competing suppliers and their products and

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<sup>13</sup> Australian Energy Market Commission, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Draft Report*, October 2007. The First Draft Report is available from the Commission's website at [www.aemc.gov.au](http://www.aemc.gov.au).

services also constrains the behaviour of retailers as they strive to retain customer patronage and increase their share of the total number of customers. In these ways, effective competition ensures that the price mechanism works effectively to allocate resources in accordance with consumer preferences. Resources move freely in response to price signals, both between and within markets, and no firm or group of firms is able to raise prices, restrict output and earn sustainable excess profits.

By constraining businesses and directing resources in this way, competition promotes economic efficiency. Competition encourages businesses to produce the goods and services that consumers want and value most at least cost, and to respond to changes in consumer tastes by offering new, different or better goods and services in a timely manner.<sup>14</sup> These and other benefits of competitive markets were noted by the Hilmer Committee which stated:<sup>15</sup>

“[the] promotion of effective competition and the protection of the competitive process are generally consistent with maximising economic efficiency.”

Where competition is effective in promoting economic efficiency, there is generally no need for price regulation. Regulation is costly, in terms of both administration and compliance costs and possible distortions to competitive market processes. It is only justified where markets are not effectively competitive, regulation can improve market outcomes and the benefits of regulation exceed the costs. This view is reflected in clause 14.11(a) of the AEMA, which requires jurisdictions to phase out retail price regulation where competition is demonstrated to be effective. This is not to say, however, that other regulatory frameworks are not required in order to overcome other market failures and thereby support competitive market processes and outcomes, e.g. prudential regulation and consumer protection provisions.

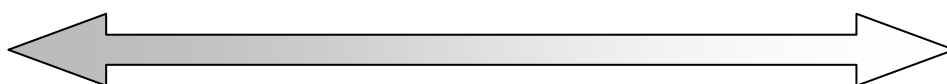
In the Statement of Approach, the Commission observed that different levels of competition may exist within a single market over time as it evolves and moves towards a perfectly competitive market. Figure 3.1 below illustrates the movement of a market away from, at one extreme, a monopoly towards, at the other extreme, a perfectly competitive market.

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<sup>14</sup> Economists often refer to these as allocative, cost and dynamic efficiencies.

<sup>15</sup> Hilmer Committee, *National Competition Policy: Report by the Independent Committee of Inquiry*, August 1993, pp. 4-5.

**Figure 3.1 Progression of competition**



Monopoly → Oligopoly → Monopolistic competition → Perfect competition

Source: AEMC, *Review of the Effectiveness of Competition the Gas and Electricity Retail Markets – Statement of Approach*, April 2007, p. 6.

There is no single point that, once reached, signals that a market is effectively (or workably) competitive. Rather, there will exist different combinations of the structural conditions, and behavioural and performance-based characteristics which may correspond to the existence of effective competition. Economic models of competition establish certain abstract formal conditions underpinning efficient market outcomes. While these models can help inform our understanding of real world markets, the Commission's approach to evaluating effective (or workable) competition, it draws on the approach adopted in relation to the development and application of competition law and policy. For any given market, an assessment of whether competition is effective will be a fact-based exercise, which assesses all of the relevant structural, behavioural and performance characteristics and their interaction.

The following explanation of effective competition was provided by the Australian Competition Tribunal:<sup>16</sup>

“As was said by the U.S. Attorney General's National Committee to study the Antitrust Laws in its report of 1955 (at p. 320): ‘The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new or potential entrants in the field, would keep this power in check by offering or threatening to offer effective inducements...’”

The Tribunal went on to say:<sup>17</sup>

“Competition expresses itself as rivalrous market behaviour. ...

In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and there should be independent

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<sup>16</sup> *Re Queensland Co-operative Milling Association; Re Defiance Holdings* (1976) 25 FLR 169 at 188.

<sup>17</sup> *Ibid.*, at pp. 188-189.

rivalry in all dimensions of the price-product-service packages offered to consumers and customers.”

The Commission has also drawn guidance from the Hilmer Committee’s statements about the characteristics of markets in which effective competition does not exist:<sup>18</sup>

“Where the conditions for workable competition are absent – such as where a firm has a legislated or natural monopoly, or the market is otherwise poorly contestable – firms may be able to charge prices above the efficient level for periods beyond those justified by past investments and risks taken or beyond a time when competitive response might reasonably be expected. Such ‘monopoly pricing’ is seen as detrimental to consumers and to the community as a whole.”

Where markets are effectively or workably competitive, there is sufficient rivalry between firms to ensure that they strive to deliver the goods and services consumers demand at least cost, and for product and process improvement. Effective competition will also ensure resources move relatively freely between and within markets in response to consumer demand and price signals.<sup>19</sup> Firms in effectively or workably competitive markets may have a degree of market power associated with product differentiation or innovation, but that market power will not be substantial or sustainable and will be subject to competitive erosion over time. At any particular point in time, resources may not be employed in their most valuable use, prices may deviate from costs and technologies can deviate from the most efficient ones available, but over time effective competition will drive the market towards efficient outcomes. Firms will continuously strive for competitive advantage against actual and potential rivals, they will seek out new profit opportunities to deliver the goods and services consumers want, and the market may always appear to be in a state of disequilibrium and change. This is the very essence of real world dynamic competition.

Rivalry between firms, and therefore the effectiveness of competition, is enhanced where there are enough customers – “switchers” – who will switch to another product or supplier in the event of a price increase or equivalent deterioration in quality or service. If there are enough switchers in the market and the firm is unable to identify the switchers from those customers that will not switch, i.e. “non-switchers”, a firm seeking to maximise its profits will be constrained in its pricing, service and quality decisions.<sup>20</sup> In most situations, including energy retailing, less

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<sup>18</sup> Hilmer Committee, *National Competition Policy: Report by the Independent Committee of Inquiry*, August 1993, p. 269. This passage was referred to by the Full Court of the Supreme Court of Western Australia in *Re Dr Ken Michael AM; ex parte EPIC Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231, para. 144.

<sup>19</sup> See, for example, Maureen Brunt, “Legislation in Search of an Objective”, in J.P. Nieuwenhuysen (ed.) *Australian Trade Practices: Readings*, 1970, Melbourne, Cheshire, p. 238, and “Market Definition Issues in Australian and New Zealand Trade Practices Litigation”, *Australian Business Law Review*, 1990, vol 18, no 2, p. 101.

<sup>20</sup> If a firm increases its price above the competitive level (or equivalently reduces the quality of its product or service) the firm’s marginal customers will switch to another product or supplier, thereby

than half the total market is required to be a switcher in order to constrain retailer behaviour.<sup>21</sup>

In evaluating the effectiveness of competition, it is important to take a forward rather than backward looking approach. Clearly, regard must be had to evidence of what has actually been happening in a market but the most important question is: what is likely to happen going forward? The past is only relevant to the extent that it is a guide to the future. It is in the future that any regulatory changes consequent to the Commission's findings will be implemented. It is therefore necessary (and appropriate) to consider the likely state of competition with and without such regulation and whether past trends are likely to continue. The Commission has been guided in its analysis by the forward-looking approach of the High and Federal Courts of Australia and the competition tribunals in competition law analysis. As the Trade Practices Tribunal observed (emphasis added):<sup>22</sup>

"In our judgment, given the policy objectives of the legislation [the Trade Practices Act], it serves no useful purpose to focus attention upon a short-run, transitory situation... This does not mean we seek to prophecy the shape of the future - to speculate upon how community tastes, or institutions, or technology might change. Rather, we ask of the evidence what is likely to happen to patterns of consumption and production were existing suppliers to raise price or, more generally, offer a poorer deal. *For the market is a field of actual or potential rivalry between firms.*"

The Commission's analysis is guided by the characteristics of effective or workable competition identified above and the factors which are most likely to combine to deliver those outcomes. The process adopted by the Commission is to identify those characteristics and to examine the extent to which they exist, and are likely to continue to exist going forward, in energy retailing in Victoria, as explained in the following section.

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reducing the number of units the firm sells. Although the firm gains margin on the retained sales (the sales it makes to non-switchers at the higher price), it loses margin on the lost sales (the sales it would have made to the switchers). As long as the firm cannot identify switchers and non-switchers and charge them different prices, a profit maximising firm will not increase price above a level that would cause it to lose enough switchers so as to make the price increase unprofitable.

<sup>21</sup> The number of switchers that are required before they are sufficient in number to impose a competitive discipline on retailers will be determined by how much each retailer's price exceeds its marginal costs (i.e. the contribution margin). The lost profit from switchers (A) is the contribution margin multiplied by the number of sales lost; that is,  $A = (p_1 - MC) \cdot (q_1 - q_2)$ . However, what is gained (B) is the difference between the lower and higher price which has been charged to "non-switchers" multiplied by the retained sales; that is,  $B = (p_2 - p_1) \cdot q_2$ . For any given price increase, the bigger the contribution margin on the lost sales, the fewer sales will need to be lost for the amount of profit lost on the "switchers" to exceed the profit gained on the "non-switchers", making the price increase unprofitable.

<sup>22</sup> *Re Tooth & Co Ltd and Tooheys Ltd* (1979) 38 FLR 1 at 38-39.

### 3.2.2 Commission's analytical approach

Markets and competitive forces are dynamic processes and, as such, any assessment of the effectiveness of competition must recognise that competition is an interactive process between market participants not a state or outcome.<sup>23</sup> There is no single criterion or set of criteria that can be used to assess the effectiveness of competition. Further, it is of little utility focusing on short-run, transitory forces.<sup>24</sup> Rather, it is necessary to consider a range of specific quantitative and qualitative factors and to understand the manner in which they combine to provide outcomes that are effective in delivering competition in the longer term and taking a forward looking approach. Accordingly, the Commission has used an integrated and dynamic analytical framework to assess the effectiveness of competition in energy retailing in Victoria.

The Commission commenced its analysis by identifying the factors that it considered were most likely to combine to deliver outcomes resulting in effective competition. In developing these, the Commission has had particular regard to both the characteristics of effective or workable competition previously identified and the MCE criteria (set out in section 3.1 above).

In considering the application of the MCE criteria to the Victorian Review, the Commission has identified three key analytical strands that have informed its approach to the assessment of effective competition. These strands, which encompass the MCE criteria, derive from the Commission's understanding of effective or workable competition, as articulated above.

For competition to be effective, a retail energy market needs to be characterised by:

- rivalrous conduct between retailers (and/or the threat of entry by new retailers) to offer the products, services, prices and other conditions of supply which are most attractive to consumers;
- informed and active consumers seeking to obtain energy products, prices and other terms and conditions of supply which best meet their needs; and
- freedom of movement for resources into and out of the market(s) in pursuit of profit opportunities, thereby eroding any excess profits over time and allocating resources to supply the goods and services most valued by consumers.

These three core characteristics of effective or workable competition underpin the three analytical strands adopted in the Commission's assessment of energy retailing in Victoria:

- the nature and extent of rivalrous behaviour between energy retailers;
- consumer behaviour, attitudes and information requirements in relation to the purchase of energy products and services; and

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<sup>23</sup> *Re Queensland Co-operative Milling Association; Re Defiance Holdings* (1976) 25 FLR 169 at 188, 189.

<sup>24</sup> *Re Tooth & Co Ltd and Tooheys Ltd* (1979) 38 FLR 1 at 38.



- the ease of entry into energy retailing in Victoria.

Each of the three analytical strands includes a number of more specific elements that are relevant to an analysis of the effectiveness of competition. While it is important to consider how a single element interacts with the others, identifying individual elements can assist in developing the analytical framework. To this end, the Commission has obtained and analysed evidence relating to a number of factors within each of the key analytical strands it has identified. These factors are substantially in line with the indicators the Commission identified in Chapter 3 of the Statement of Approach. Through its analysis, the Commission reached an informed view about the materiality of each factor to the assessment of competition. In addition, the Commission was able to evaluate the interactions between each of the factors in order to reach an overall assessment of the process of competition in energy retailing to the domestic and small business customer segment in Victoria.

The first strand of the Commission's analysis examined the nature and extent of rivalrous behaviour between retailers. The factors considered by the Commission included:

- price rivalry between retailers;
- differentiation of products and services between retailers to better meet customer requirements than their rivals;
- proactive and defensive marketing strategies by retailers to obtain new customers and retain existing ones;
- differences in business and marketing models (e.g. between different host retailers and between host and new retailers) to attract customers, manage customer churn and remain viable in a volatile market environment;
- the ability of retailers to identify and discriminate between groups of customers in their price, product and service offers;
- the impact of regulation on retailers' competitive activity, including marketing, price, product and service offerings;
- indicators of compliance and non-compliance with regulatory obligations and customer complaints about retailer service; and
- price and profit levels and trends across and between retailers.

The second analytical strand considered the behaviour of customers in exercising retailer choice. In conducting this part of its analysis, the Commission considered indicators of the presence (or absence) of informed customer choice and switching behaviour that is likely to exert competitive pressure on retailers. This included:

- the extent to which customers are aware that they can choose their energy supplier and are relatively knowledgeable about the types of products and service offerings available in the market;

- the extent to which customers are exercising choice by entering into market contracts and changing retailers in response to the price and service offers available to them;
- customers' willingness to act on market information to choose those energy retailers and products which best meet their needs;
- customers' ability to access and understand information enabling them to compare products and service offerings, and their preparedness to undertake such investigations;
- customer attitudes to retail energy brands and their willingness to try new retailers; and
- the impact of regulation in assisting or deterring the exercise of effective consumer choice in relation to retail energy products.

The final strand of the Commission's analysis assessed the impact of entry, expansion and exit conditions on competition, including:

- the conditions for entry and expansion in energy retailing, including access to and the cost of contracts for energy supply and risk management facilities, the presence of economies of scale and scope, and the sunk costs of customer acquisition and retail operations; and
- the impact of regulatory requirements such as licensing, retail price regulation and customer service obligations on entry costs and risks.

The Commission's analysis of these three key strands, the factors that underpin them, and the materiality of their impact on the effectiveness of competition is contained in Chapters 5 to 8 of the First Final Report. The analysis also underpins the Commission's discussion in Chapter 9 of the specific classes of customers who may not be able to access the full benefits of effective competition.

### **3.2.2.1 Information gathering and consultation**

An integral input to the Commission's analysis is gathering information and testing the robustness of that information through consultation with stakeholders. The information gathering exercises and the consultative processes undertaken by the Commission are outlined in this section.

To ensure the Commission's assessment of the effectiveness of retail energy competition in Victoria is robust, it engaged in a range of information gathering exercises, including a variety of consultative processes.

As noted in section 3.1, on 1 June 2007 the Commission released an Issues Paper calling for submissions from interested parties on a number of matters concerning

retail energy competition and the experiences of energy customers specific to Victoria. The Commission received 13 submissions<sup>25</sup> which it considered in the course of preparing the First Draft Report and the First Final Report. The Commission has also had regard to those submissions to the Draft Statement of Approach that raised issues relevant to matters canvassed in the First Draft Report and the First Final Report.

In June 2007, the Commission published two reports that it commissioned from NERA Economic Consulting (NERA). The first report outlines the structure of the gas supply chain in Eastern Australia, its competitive environment and potential implications for competition at the retail level. The second report outlines these issues in relation to the wholesale supply of electricity in Australia. The Commission published these reports on its website and invited interested parties to provide any relevant observations in relation to their contents to the Commission. No such observations have been received.

The MCE criteria require the Commission to consider prices and profit margins in assessing the effectiveness of competition.<sup>26</sup> To this end, the Commission engaged CRA to provide data analysis and advice about the profit margins in electricity and gas retailing in Victoria. At the time of the publication of the First Draft Report, CRA had only made the preliminary results of its analysis available to the Commission. The Commission has since received CRA's final analysis and published the report on its website. The Commission invited stakeholders to comment on CRA's report but no submissions have been received.<sup>27</sup>

The Commission also sought quantitative information directly from retailers. In June 2007, the Commission issued a data template to each retailer seeking quantitative data about their customer numbers, revenue, customer transfers, costs and margins, energy sales and green energy offerings. The Commission has used data collected via the template in a range of analytical contexts, including its assessment of the nature and extent of rivalrous behaviour between retailers and the impact of entry conditions on competition.

To understand energy retailing from the retailers' perspectives, the Commission invited retailers to participate in a written survey (Retailer Survey). The Commission engaged Wallis Consulting Group Pty Ltd (Wallis Consulting), a Melbourne-based market research firm, to undertake the survey on its behalf.

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<sup>25</sup> Submissions were received from AGL Energy, Consumer Action Law Centre, Consumer Utilities Advocacy Centre, Energy and Water Ombudsman (Victoria), Energy Retailers Association of Australia, Footscray Community Legal Centre, GridX, Origin Energy, St Vincent de Paul Society, Tenants Union of Victoria, TRUenergy and Victorian Council of Social Services. The Commission also received correspondence from a private citizen expressing an intention to provide a submission. While no submission was provided, the Commission has treated the materials annexed to the correspondence as a submission for present purposes.

<sup>26</sup> MCE, Request for Advice, Appendix 1.

<sup>27</sup> Only two submissions commented on CRA's preliminary results as incorporated into the First Draft Report: Consumer Action Law Centre, submission to the First Draft Report, p. 10; Madeleine Kingston, submission to the First Draft Report, pp. 103-107.

The Retailer Survey provided each retailer with the opportunity to provide focused and comparable information on specific issues that the Commission considered were relevant to the Victorian Review. The survey also sought information from each retailer about their current market contracts (including price).<sup>28</sup> At the completion of the survey, officers of the Commission and representatives of Wallis Consulting met with each retailer to seek their views about trends and specific issues arising from responses to the survey and, where necessary, elaboration on the views expressed in the retailer's survey response. Wallis Consulting has collated the survey responses and additional information provided during the follow-up meetings and has prepared a report for the Commission.

Wallis Consulting was also engaged to conduct a telephone survey of 1,000 domestic and 500 small business energy customers located in Melbourne, regional centres<sup>29</sup> and other rural areas in Victoria (Consumer Survey). The objective of the Consumer Survey was to obtain quantitative data to assist the Commission to assess whether competition is effective for domestic and small business customers. Wallis Consulting has prepared a separate report for the Commission interpreting the results of this survey.

Non-confidential versions of the reports by NERA and Wallis Consulting are available on the Commission's website. Interested parties were invited to review the reports and to provide any relevant observations in relation to their contents to the Commission as part of a response to the First Draft Report. Observations in response to the report by CRA were invited once the completed report was made available.

The joint submission from Victorian consumer groups to the Draft Statement of Approach urged the Commission to consult with consumer stakeholders, including rural and regional customers.<sup>30</sup> As part of this process, the Commission held consultation forums in Melbourne and Bendigo that members of the public and interested stakeholders were invited to attend. The purpose of the forums was to provide information to consumers about the Victorian Review and to hear from domestic and small business customers about their experiences of energy retailing in Victoria.

In October 2007, the Commission published the First Draft Report. It invited interested parties to make submissions in response to the preliminary findings contained in the Report and the material supporting them, as well as any other matter considered to be pertinent to the Commission's analysis of the effectiveness of

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<sup>28</sup> This information was forwarded to CRA and served as a data input to CRA's report.

<sup>29</sup> For the purpose of the Consumer Survey, the regional centres include Ballarat, Bendigo, Geelong, Mildura, Morwell, Shepparton, Warrnambool and Wodonga.

<sup>30</sup> Joint submission from Victorian consumer groups (Consumer Utilities Advocacy Centre, Victorian Council of Social Service, Alternative Technology Association and St Vincent de Paul Society Victoria), p. 6. The Consumer Action Law Centre's submission to the Draft Statement of Approach also urged the Commission to undertake rigorous consultation with representatives of residential customers (p. 4).

competition. The Commission received a total of 22 submissions<sup>31</sup> which it has taken into consideration in preparing the First Final Report.<sup>32</sup>

Throughout the Victorian Review, the Commission has also maintained an ongoing dialogue with various stakeholders, including representatives of the Victorian Government, the ESC and community and welfare groups.

### **3.2.2.2 Additional information sources**

As part of its assessment, the Commission has sought to understand how competition has developed since the introduction of FRC. An important input to this analysis has been the reviews of the effectiveness of retail competition undertaken by the ESC. The first review, conducted in 2002, was limited to an examination of the electricity sector (2002 ESC Review). The second review, conducted in 2004, examined retail competition for both electricity and gas (2004 ESC Review).

In the context of the Commission's task, as defined by the AEMA, the Request for Advice, and articulated in the Statement of Approach, the work the ESC has completed to date is relevant to the Victorian Review. While the Commission has gathered its own data and evidence in order to make an assessment of the effectiveness of competition, it has had regard to the ESC's findings where they provide an indication of trends and the development (or decline) of competition in the market.

As noted above, the Commission has also taken account of the submissions received in response to the Draft Statement of Approach, the Issues Paper and the First Draft Report in analysing the issues canvassed in the First Final Report.

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<sup>31</sup> Submissions were received from AGL Energy; Dr Kalissa Alexeyeff; Alternative Technology Association; Australian Power & Gas; Centre for Consumer and Credit Law (Griffith University); Minister for Energy, The Hon Patrick Conlon MP; Consumer Action Law Centre; Consumer Utilities Advocacy Centre; Energy Supply Association of Australia; Energy and Water Ombudsman (Victoria); Ms Madeleine Kingston (x2); Origin Energy; Public Interest Advocacy Centre; Red Energy; Simply Energy (x2); St Vincent de Paul; TRUenergy; Victoria Electricity; and Victorian Council of Social Services. The Commission also received two submissions from end use customers which for privacy reasons, were published under the name "End Use Customer 1" and "End Use Customer 2".

<sup>32</sup> The submissions from Australian Power & Gas and the Energy and Water Ombudsman (Victoria) contained information that was provided subject to a claim for confidentiality. The Commission has published these submissions omitting the confidential information. In considering the weight to be attributed to this confidential information, the Commission has taken into account that the information has not been tested.

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## **4 Retailing Energy in Victoria**

Since the early 1990s, energy supply in Victoria has undergone a number of reforms designed to encourage the development of a fully competitive and integrated energy market, culminating in the introduction of full retail competition (FRC). In preparation for, and subsequent to, the start of FRC a range of obligations were imposed upon retailers in order to encourage competition and to safeguard consumers during the transition to competition. These reforms, and the obligations borne by retailers, are not only relevant background for the Victorian Review; they are also factors that may impact on the effectiveness of competition.

While the effects of the reforms and regulatory interventions on competition are discussed in successive chapters of the First Final Report, this chapter describes the restructuring, corporatisation and privatisation of energy businesses in Victoria that took place in the lead up to FRC. In recounting the history of energy reform, this chapter also provides insight into the Victorian Government's policy rationale for the introduction of the "safety net" designed to guide customers through the transition to effective retail competition. Chapter 4 also provides a high level, factual description of the businesses retailing energy in Victoria and some of the key characteristics of the retail energy customer base, and concludes by summarising the current regulatory obligations that are pertinent to the Victorian Review.

### **4.1 History of full retail competition**

#### **4.1.1 Industry re-structuring**

In the early 1990s the Victorian Government commenced a process of restructuring, corporatising and privatising the government-owned energy assets and businesses. As part of the restructuring process, the Government established a number of corporatised retail businesses. In the electricity sector, the retail businesses were initially integrated with the distribution network businesses serving the same geographic areas, whereas in gas, the retail businesses were established as separate corporate entities but "stapled" (or joined) to the corresponding distribution business. Unlike electricity, the geographic areas serviced by each gas retailer overlapped but did not mirror the geographic distribution areas; rather, a single distribution area was divided between two retailers. Table 4.1 below shows each of the electricity and gas retail businesses and their stapled distribution businesses at the time they were corporatised.

**Table 4.1 Victorian corporatised retail and distribution businesses**

<b>Electricity retail business</b>	<b>Integrated electricity distribution business</b>
CitiPower	CitiPower
Eastern Energy	Eastern Energy
Powercor Australia	Powercor Australia
Solaris Power	Solaris Power
United Energy	United Energy
<b>Gas retail business</b>	<b>Stapled gas distribution business</b>
Energy 21	Stratus Networks
Ikon Energy	Multinet
Kinetik Energy	Westar

Sources: Parliament of Australia, Parliamentary Library, *Electricity Industry Restructuring – A Chronology*, Background Paper 21 1997-98; *Alinta Asset Management Pty Limited v Essential Services Commission* [2007] VSC 210.

Each integrated or stapled business was operated by a lessee or an operating company but remained government-owned. The lessee/operating company was granted a retail licence and distribution licence for an unlimited term (subject to compliance with licence provisions). Each electricity and gas retailer was allocated customers based on their geographic area of operation. These customers subsequently became known as the “franchise customers” of the retailer and the area of operation as the “franchise area”. Following the introduction of competition, retailers became the “local” or “host” retailer for their franchise customers.

In 1995, the electricity retail and distribution arms were sold by the Victorian Government as integrated businesses to private interests. The stapled gas retail and distribution businesses were sold in the first quarter of 1999. The purchasers of the privatised businesses are set out in Table 4.2 below.



**Table 4.2 Purchasers of Victorian corporatised energy businesses**

<b>Electricity</b>	<b>Purchaser</b>
CitiPower	Ent Energy Corp (US)
Eastern Energy	Texas Utilities Australia Limited
Powercor	Pacificorp (US)
Solaris	Consortium including AGL and Energy Initiatives Inc (US)
United Energy	Utilitcorp consortium (US)
<b>Gas</b>	<b>Purchaser</b>
Energy 21/Stratus	Consortium including Boral Energy Limited and Envestra Limited
Ikon Energy/Multinet	Energy Partnership Pty Ltd
Kinetik Energy/Westar	Texas Utilities Australia Limited

Sources: Parliament of Australia, Parliamentary Library, *Electricity Industry Restructuring – A Chronology*, Background Paper 21 1997-98; Firecone Ventures, *A report to the Department of Infrastructure*, Victoria, August 2006, pp. 14-15; *Alinta Asset Management Pty Limited v Essential Services Commission* [2007] VSC 210.

Following privatisation, Victoria was serviced by five electricity host retailers and three for gas. Each retailer operated as the franchised monopoly retailer in its prescribed area.

Subsequently, the electricity and gas distribution businesses were separated from retail businesses. Although the initial restructuring and privatisation process created five electricity host retailers in Victoria, a series of acquisitions has resulted in there now being only three electricity host retailers in Victoria: AGL Energy (AGL), Origin Energy and TRUenergy. These businesses are also the Victorian host retailers for gas. Further information about the energy retail businesses currently operating in Victoria is contained in section 4.2 of this chapter.

#### **4.1.2 Full retail competition**

Retail competition in both the gas and electricity sectors has been introduced progressively. At the introduction of competition in Victoria, only the largest industrial and commercial energy users could choose between the host retailers and new entrant energy suppliers. Over time, the ability to select an energy retailer has been progressively extended to more customers, classified on the basis of the size of their annual energy consumption. FRC exists where all customers – including the smallest users of energy – are able to choose their retailer.

FRC was introduced in Victoria on 13 January 2002 for electricity and 26 October 2002 for gas in conjunction with a framework of regulatory safeguards for domestic and small business customers. Table 4.3 below describes the staged introduction of retail competition in Victoria.

**Table 4.3: Timetable for introduction of FRC in Victoria**

Date of eligibility	Threshold customer load	Estimated number of eligible customers
<b>Electricity</b>		
December 1994	In excess of 5 MW (demand)	47
July 1995	In excess of 1 MW (demand)	330
July 1996	In excess of 750 MWh per annum	1500
July 1998	In excess of 160 MWh per annum	5000
January 2001	In excess of 40 MWh per annum	35000
January 2002	All remaining customers	2.1 million
<b>Gas</b>		
1 October 1999	In excess of 500 TJ per annum	35
1 March 2000	In excess of 100 TJ per annum	110
1 September 2000	In excess of 10 TJ per annum	600
1 September 2001	In excess of 5 TJ per annum	600
1 October 2002	All remaining customers	1.4 million

Source: ESC, *Review of the Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity – Background Report*, 22 June 2004, p. 10.

## 4.2 Participants in energy retailing in Victoria

As noted in the previous chapter, the First Final Report sets out the Commission's assessment of the effectiveness of competition according to three analytical strands. In preparation for this analysis, this section provides some factual background about the nature of energy retailing and the individual businesses who are engaged in energy retailing. It concludes by making some observations about the nature of energy demand facing retailers and setting out factual material relating to customer participation in energy retailing in Victoria.

### 4.2.1 The energy retail function

Retailers contract with domestic and small business customers in Victoria, under either a standing offer or market contract, to sell delivered energy at specified prices. Retailers purchase wholesale energy to meet the needs of these customers at prices which can fluctuate over the short-term. The central function performed by an energy retailer in any Australian jurisdiction is therefore to act as an intermediary between the entity who produces the energy (i.e. the electricity generator or the gas producer) and the end use customer. In performing this role, the retailer manages the price and volume risk faced by the customer in exchange for a risk premium which is incorporated into the retail price of the energy. The efficient management of this risk is a key area in which retailers can compete.<sup>33</sup> The electricity retail function was described by the Federal Court in the following way:<sup>34</sup>

<sup>33</sup> Ofgem has estimated that competition between British energy retailers has saved each customer more than £100 on average by protecting them from the impact of rising wholesale prices over the past four years: Ofgem, *Domestic Retail Market Report*, June 2007, pp. 1-8.

<sup>34</sup> *Australian Gas Light Company (ACN 052 167 405) v Australian Competition and Consumer Commission (No 3)* (2003) ATPR 41-966 at 47,647.

“The retail function in the NEM does not refer to any underlying physical delivery of electricity from retailer to customer. The electricity flows from generators through transmission and distribution lines to the end users. That flow is not controlled by the retailer. The retail function rather describes the assumption, by the retailer, of liabilities to the generator in respect of electricity for which the retailer is paid by the consumer.”

Similarly, a gas retailer does not control or otherwise direct the flow of gas from the place of production to the end user through the transmission and distribution networks. Rather, akin to electricity, a gas retailer assumes the liabilities and risks of purchasing gas directly from producers and, in selling gas to the customer, charges a price for the energy and an appropriate return for the assumption of risk.

Accordingly, the retail price for each unit of electricity or gas comprises the wholesale price of the energy, the charges for transporting energy from the place of production to the consumer’s location, the variable costs incurred by the retailer in supplying the energy, a contribution towards its fixed costs, taxes and other levies, and a margin for risk and profit. The quantum of these price components will be affected by any regulatory intervention but also by the effectiveness of competition between rivalrous suppliers of the component goods or services.

#### **4.2.2 Victorian energy retailers**

The introduction of FRC enabled new entrant retailers to compete with host retailers to offer to sell gas and electricity to the final tranche of customers, being the smallest users of energy. In January 2002, when FRC commenced for electricity, 18 retailers held retail licences in Victoria.<sup>35</sup> When FRC was introduced for gas in October 2002, eight businesses were licensed to retail gas.<sup>36</sup>

As at 1 December 2007, the ESC had issued 27 electricity retail licences and 13 gas retail licences. However, not all entities holding a retail licence sell energy to domestic and/or small business customers in Victoria. Some licensees have chosen not to retail energy to this customer class<sup>37</sup>, or are not licensed to<sup>38</sup>, are licensed to but have not yet launched their retail operations.<sup>39</sup> Others are part of the same corporate group and trade under the same corporate brand. For example, AGL Sales Pty Ltd and AGL Sales (Queensland) Pty Ltd each hold a Victorian gas retail licence but both trade under the AGL brand. Taking these matters into account, there are presently 13 electricity businesses and 6 gas businesses that retail energy to domestic or small business customers in Victoria. These retail businesses, referred to in the First Final Report as retailers, are identified in Table 4.4 below.

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<sup>35</sup> Essential Services Commission, *Review of the Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity – Background Report*, 2004, p. 23.

<sup>36</sup> *Ibid.*, p. 21.

<sup>37</sup> For example, in the case of electricity, Aurora Energy Pty Ltd and Integral Energy Australia.

<sup>38</sup> For example, in the case of gas, BHP Petroleum (Bass Strait) Pty Ltd, Esso Australia Resources Pty Ltd and Santos Direct Pty Ltd.

<sup>39</sup> For example, for both electricity and gas, Dodo Power & Gas Pty Ltd.

**Table 4.4: Victorian energy retail businesses**

Retail business	Electricity retail licensee	Gas retail licensee
Australian Power & Gas	✓	✓
AGL Energy	✓	✓
Click Energy	✓	✗
Country Energy	✓	✗
Dodo Power & Gas	✓	✓
Jackgreen	✓	✗
Momentum Energy	✓	✗
Neighbourhood Energy	✓	✗
Origin Energy	✓	✓
Powerdirect	✓	✗
Red Energy	✓	✓
Simply Energy*	✓	✓
TRUenergy	✓	✓
Victoria Electricity	✓	✓

\* formerly the EA-IPR Retail Partnership trading as EnergyAustralia.

Sources: Retailer interviews conducted by Wallis Consulting and the Australian Energy Market Commission, July 2007 and ESC website.

The Victorian retailers comprise a spectrum of sizes, types and business models. The three host retailers – AGL, Origin Energy and TRUenergy – retail energy to a substantial majority of the customer base in Victoria. AGL and Origin Energy also operate host retailer businesses in other jurisdictions. Retailers operating in other jurisdictions have also extended their retail operations to include Victoria, for example, Country Energy and Jackgreen. There has also been significant “de-novo” entry, with a number of retailers establishing their energy retailing businesses in Victoria before any other Australian jurisdiction. De novo retailers include Click Energy, Dodo Power & Gas, Neighbourhood Energy and Victoria Electricity. Penetration by new retailers in Victoria is increasing and several retailers have built strong customer bases from which they compete vigorously with the host retailers. Alternatively, some retailers are focused on providing product offerings that serve a particular market niche, or bundling energy services with other retail utility services.

The retailers also differ in their ownership structures. Australian Power & Gas, AGL, Jackgreen, Origin Energy and Powerdirect are each part of a different corporate group whose ultimate holding company is listed on the ASX. Victoria Electricity is wholly owned by Infratil Limited, a company listed on the New Zealand stock exchange, and TRUenergy is part of the CLP Group, which is listed on the stock exchange in Hong Kong. Country Energy is owned by the NSW Government and, until August 2007, Simply Energy was a partnership between EnergyAustralia (another NSW Government-owned retail business) and International Power (Australia) Pty Ltd trading under the EnergyAustralia name.<sup>40</sup> The remaining retailers are incorporated and privately held.

For some corporate groups, the energy retail business forms part of a broader portfolio of assets and commercial interests. For example, a number of retailers are

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<sup>40</sup> Simply Energy is now wholly owned by International Power (Australia) Pty Ltd.

affiliated with electricity generation assets.<sup>41</sup> The extent to which each retailer remains a net purchaser of electricity reflects differing views held by the respective corporate groups about the optimum risk management strategy. Similarly, some corporate groups hold interests in natural gas and coal seam methane exploration and production assets<sup>42</sup>, energy network assets and asset management services<sup>43</sup>, and/or non-energy assets.<sup>44</sup> The diversity in the assets held by the different corporate groups reflects each group's views about how best to structure asset portfolios and minimise their cost of capital.

Additional information about each of these retailers, including about their interstate energy retailing businesses is contained in Appendix A. Further information about electricity generation and gas production assets affiliated with Victorian retail businesses is contained in the reports commissioned from NERA which are available on the Commission's website.

#### **4.2.3 Changes in retailer shares**

To assess whether competition is effective, it is necessary to understand the extent to which new retailers have been able to attract customers to switch away from the host retailers. Considering first the size of each retailer's share of customer connections, for each fuel and by each contract type (i.e. all domestic or small business customers, market contract customers only and dual fuel contracts), the host retailers have the three largest individual shares. However, the aggregation of these shares in Figures 4.1 and 4.2 illustrates the steady erosion of the host retailers' customer shares since the introduction of FRC. Their collective share is described by the three firm concentration ratio (CR3). By the end of 2006, the CR3 for electricity connections had fallen to 80 per cent and new entrants were retailing electricity to 20 per cent of domestic or small business electricity customers, while the CR3 for gas connections had fallen to 88 per cent, and 12 per cent of gas customers were supplied by new entrants.<sup>45</sup> The downward pressure exerted by new retailers is also observed from the results of the four-firm concentration ratio (CR4) and the Herfindahl Hirschman Index (HHI), which show a steady decline in overall market concentration since 2003.<sup>46</sup>

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<sup>41</sup> For example, AGL, Origin Energy, Red Energy, Simply Energy, TRUenergy, and Victoria Electricity.

<sup>42</sup> For example, AGL and Origin Energy.

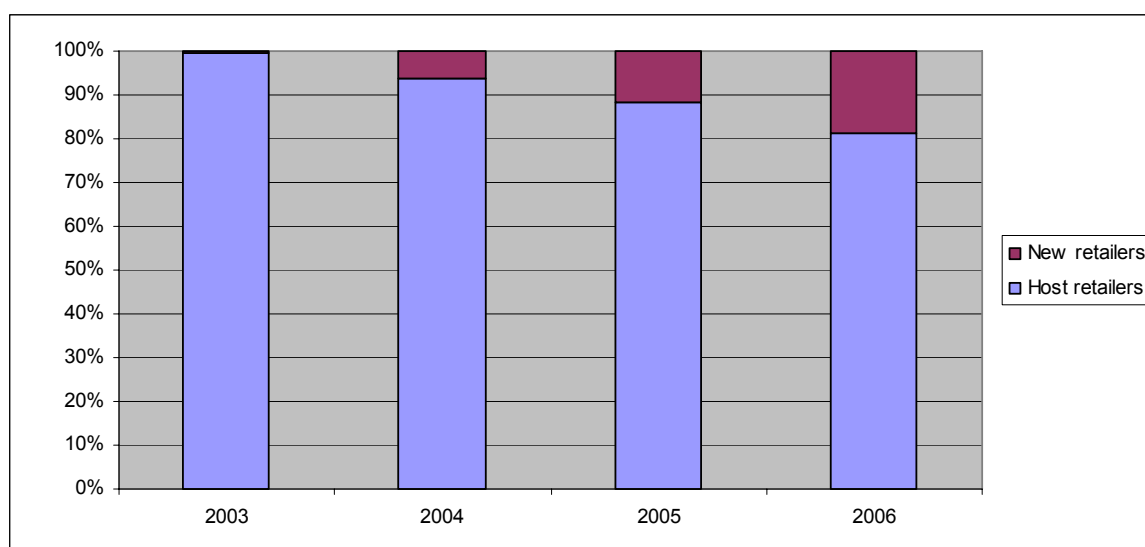
<sup>43</sup> For example, Origin Energy.

<sup>44</sup> For example, Infratil Limited owns and operates a range of businesses in the airport and public transport sectors in New Zealand and overseas.

<sup>45</sup> CRA's report cites slightly different customer shares for the host retailers. The Commission expects that this is attributable to differences in the underlying data.

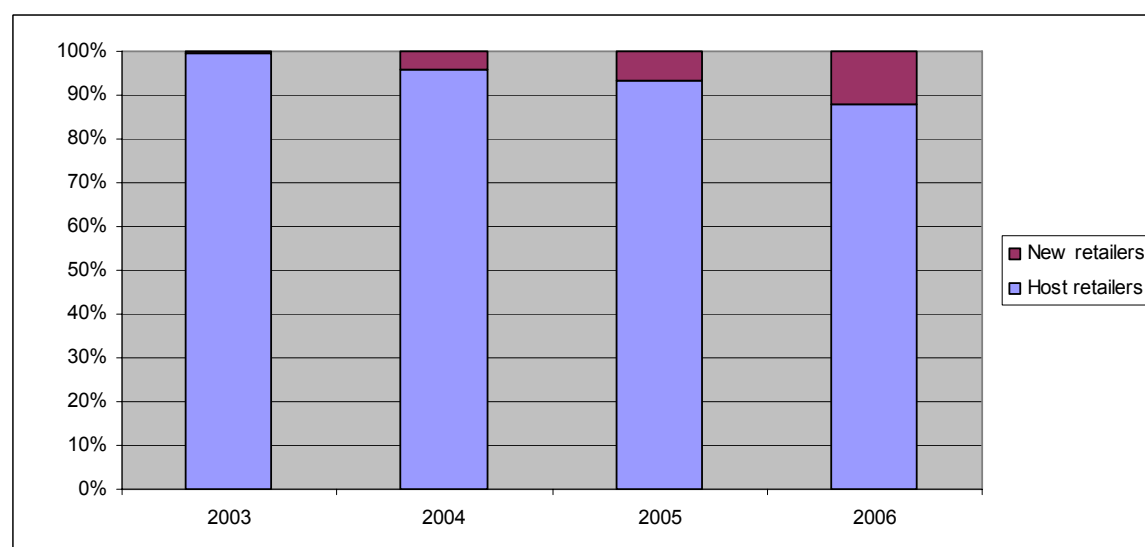
<sup>46</sup> Based on the data provided to the Commission by retailers, the CR4 shows that the combined customer share of the four largest retailers in 2003 was almost 100 per cent, in both electricity and gas. Concentration declined to 88 per cent for electricity and 97 per cent for gas by the end of 2006. Similar results were obtained using the HHI. The submission from the South Australian Minister for Energy queried the apparent absence of a concentration ratio analysis in the First Draft Report, given an expectation, arising from the Statement of Approach, that this kind of analysis would be undertaken. The First Draft Report did examine the CR3, which reflects the combined customer share of the host retailers. While the CR4 and HHI may be useful first indicators of the structure of

**Figure 4.1 Shares of total domestic or small business electricity customers**



Data source: AEMC retailer data template.

**Figure 4.2 Shares of total domestic or small business gas customers**



Data source: AEMC retailer data template.

The aggregated customer shares of new retailers is higher when the number of customers on standing offer and deemed contracts are removed and only those customers on market contracts are considered. However, the same trend is evident

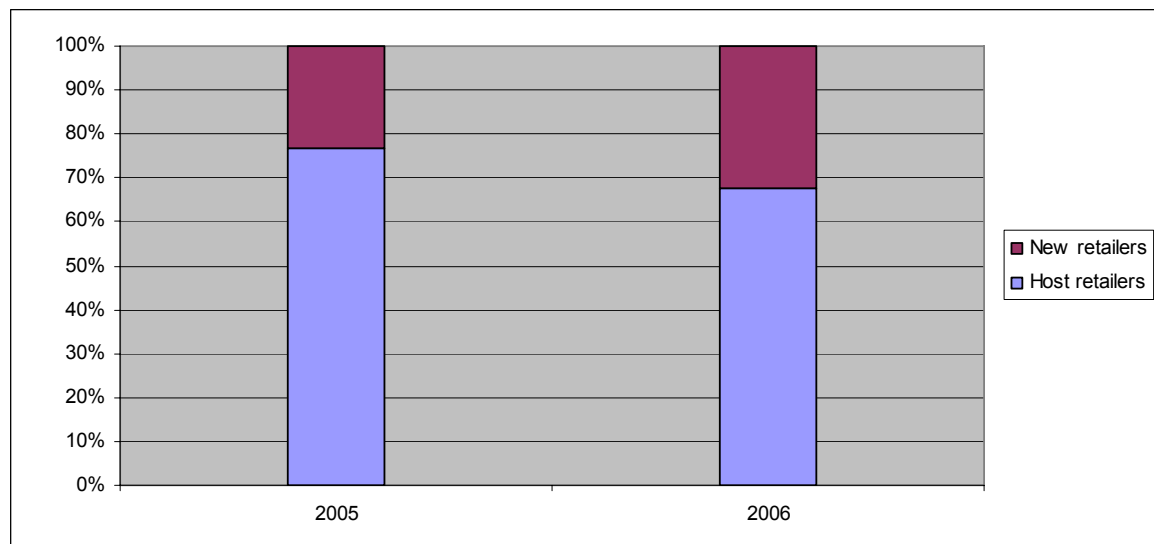
the sector, they must be considered in light of other factors. As the Trade Practices Tribunal noted in *Re Queensland Co-operative Milling Association; Re Defiance Holdings Ltd* (1976) 25 FLR 169 at 189:

“significantly lower market concentration is preferable to a high level. But other things are rarely likely equal... Moreover the very significance of the change in the concentration ratio will depend upon other competitive characteristics of the industry.”

Further information about the uses and limitations of the CR4 and HHI is provided in Appendix B.

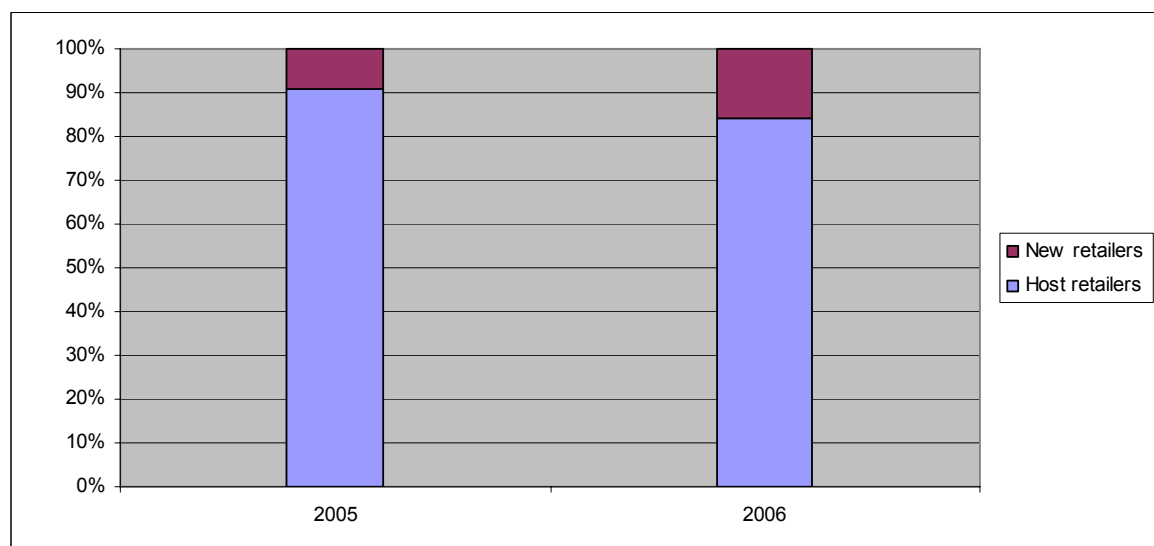
and by the end of 2006, new retailers serviced 32 per cent of electricity and 16 per cent of gas customers on a market contract. These trends are represented in Figures 4.3 and 4.4 below.

**Figure 4.3 Shares of electricity customers on market contracts**



Data source: AEMC retailer data template.

**Figure 4.4 Shares of gas customers on market contracts**



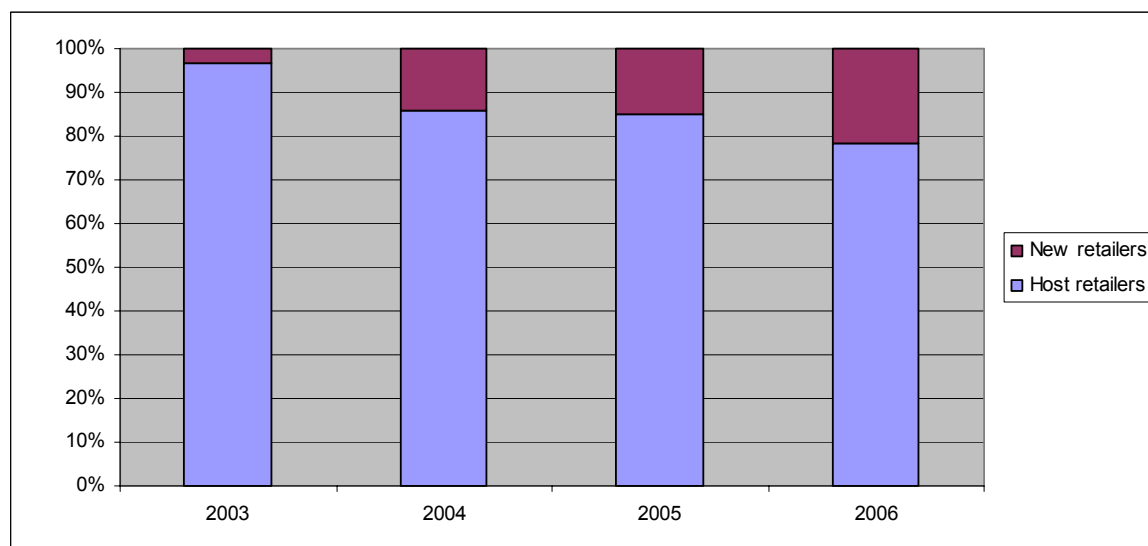
Data source: AEMC retailer data template.

The uptake of market contracts for dual fuel products also shows increased penetration by new retailers. For the purpose of the First Final Report, a “dual fuel”

customer is a customer who has entered into a single contract with a retailer, or two contracts with the same retailer, for the retail sale and supply of electricity and gas.<sup>47</sup>

The data collected from retailers indicates that by the end of 2006, 22 per cent of customers who acquired gas and electricity from the same retailer were contracted to a new retailer.

**Figure 4.5 Shares of dual fuel customers**



Data source: AEMC retailer data template; ESC various sources.

The implications for competition of rivalry between retailers for customer shares and of customer switching behaviour is analysed in detail in Chapters 5 and 6 of the First Final Report. However, an important input to assessing their implications is an understanding of the nature of demand for energy products and current levels of customer participation in energy retailing.

#### 4.2.4 Victorian energy retail customers

The demand for any product or service is a function of consumer tastes, the price, quality and variety of available products/services, the availability of substitutable products or services and the availability and price of any products or services consumed in conjunction with the primary product or service. Demand is also reflective of the income of consumers and the transaction, switching and search costs

<sup>47</sup> The Commission acknowledges that the Energy Retail Code ascribes a specific meaning to the term “dual fuel contract”; specifically, that the gas and electricity are supplied pursuant to a single contract or two separate contracts under which the billing cycles are synchronised. For the purpose of the First Final Report, the Commission’s use of the term “dual fuel customer” should be taken to mean a customer who is supplied electricity and gas pursuant to a single contract or pursuant to two separate contracts by a single retailer. It does not take account of the synchronicity of the billing cycles of customers’ retail contracts.



associated with selecting one product or service over another. The nature of demand for energy products will affect the extent to which customers are willing to participate in a competitive energy market and potentially the effectiveness of competition.

Energy is an essential service and consumers place a high priority on it being reliable. Electricity and gas supply are homogenous services. The reliability and security of supply incentives and obligations that apply in the NEM and the safety obligations that apply to the transportation and supply of gas normally deliver the high levels of energy reliability that customers require. Although retailers can differentiate energy services on the basis of price, service and non-price incentives, consumers generally regard energy supply as an undifferentiated commodity. There is some substitutability between gas and electricity (e.g. in cooking, water heating and space heating) but, as noted by the Consumer Action Law Centre<sup>48</sup>, for the majority of uses there is no alternative to electricity. Further, there is an increasing number of electricity-dependent appliances and the price of these appliances is falling. This, coupled with economic growth and rising household incomes, is increasing demand for energy. These characteristics of energy demand are reflected in a relatively low price elasticity of demand for energy, and for electricity in particular, where an increase in price normally results in a less than proportionate reduction in demand.<sup>49</sup>

These features of energy demand may also contribute to a perception on the part of some customers that the search and transaction costs associated with actively seeking out and acquiring the most suitable energy product outweigh the benefits of switching. However, actual or perceived search and switching costs are likely to be less of a deterrent as energy consumption increases or as energy prices increase. Retail energy customers may also exhibit “status quo bias”<sup>50</sup>, remaining with their existing retailer even in the presence of potential net gains from switching. This may be particularly prevalent in recently de-regulated markets previously supplied by government monopolies, but is likely to erode over time. However, as discussed in Chapters 5 and in this chapter below, low levels of interest amongst customers creates incentives for retailers to reduce customers’ search costs by using direct marketing to present customers with relevant information and comparisons which allow them to exercise choice at low cost with minimum sacrifice of time and effort.

As at 31 December 2006, there were approximately 2.4 million domestic or small business electricity customers in Victoria and in excess of 1.6 million such gas

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<sup>48</sup> Consumer Action Law Centre, submission to the First Draft Report, p. 2.

<sup>49</sup> See, for example, National Institute of Economic and Industry Research, *The own price elasticity of demand for electricity in NEM regions: A report for the National Electricity Market Management Company*, June 2007; Australian Bureau of Agricultural and Resource Economics, *Price Elasticities of Australian Energy Demand*, September 1996.

<sup>50</sup> C. Camerer, S. Issacharoff, G. Lowenstein, T. O’Donoghue and M. Rabin, “Regulation for Conservatives: Behavioural Economics and the Case for ‘Asymmetric Paternalism’”, *University of Pennsylvania Law Review*, 2003, Vol 151 No 121, p.1,224. The authors cite W. Samuelson and R. Zeckhauser, “Status Quo Bias in Decision Making”, *Journal of Risk and Uncertainty*, 1988, Vol 7.

customers. Of these, domestic customers represented the majority of customers in both electricity (88 per cent) and gas (97 per cent).<sup>51</sup>

The Consumer Survey reveals a high level of awareness of FRC amongst these customers and that they have a favourable view of what FRC means for them, principally, the opportunity to choose their energy supplier. For both the domestic customer class and the small business customer class, 94 per cent know that they can choose their electricity retailer. Amongst customers connected to mains gas, awareness of choice was 91 per cent for domestic customers and 95 per cent for small business customers. These awareness levels are higher than those recorded by the ESC in 2004; specifically, 90 per cent for electricity and 83 per cent and 89 per cent for domestic and small business gas customers respectively.<sup>52</sup>

In addition to being aware of their ability to choose, customers also appear to be more aware of alternate energy retailers than they were in 2004. Of all small customers recently surveyed, around two thirds could name an alternate electricity retailer and approximately 50 per cent an alternate gas retailer other than the retailer with whom they had a contract, up from 50 per cent and 40 per cent in 2004 respectively.<sup>53</sup> Awareness of host retailers AGL, Origin Energy and TRUenergy is significantly greater than that of new retailers, although at least one new electricity retailer, Red Energy, is relatively well known, particularly in rural and regional areas (as opposed to metropolitan Melbourne).

The Consumer Survey results also show that domestic and small business customers value the opportunity to choose their retailer. The results, set out in Figure 4.6 below, show that an overwhelming majority of all customers surveyed value choice and only 11-12 per cent do not. This is, in itself, a benefit of competition, quite apart from lower prices and other benefits which might flow to customers.

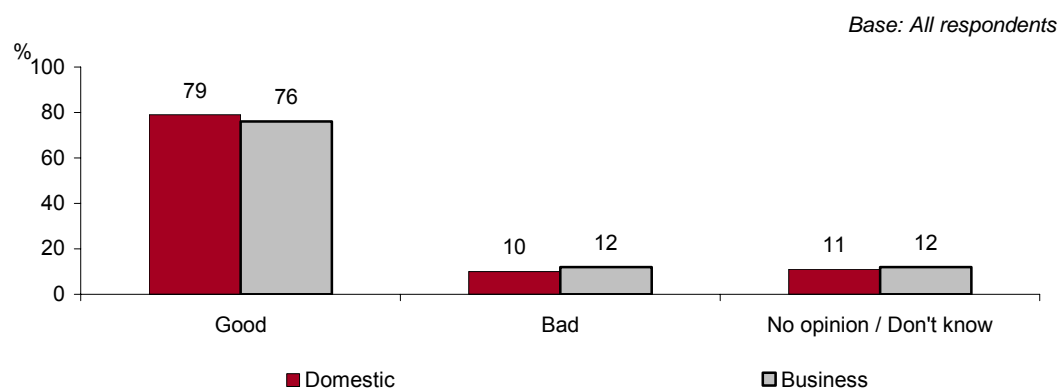
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<sup>51</sup> AEMC retailer data template.

<sup>52</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 13.

<sup>53</sup> *Ibid*, pp. 16-21; Essential Services Commission, *Special Investigation – Review of the effectiveness of retail competition in gas and electricity*, 2004, p. 50.

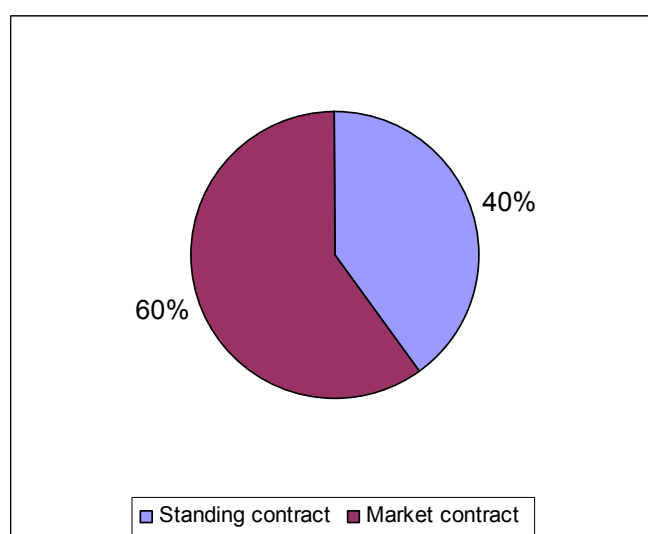
**Figure 4.6 Customer attitudes to FRC**



Source : Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 59.

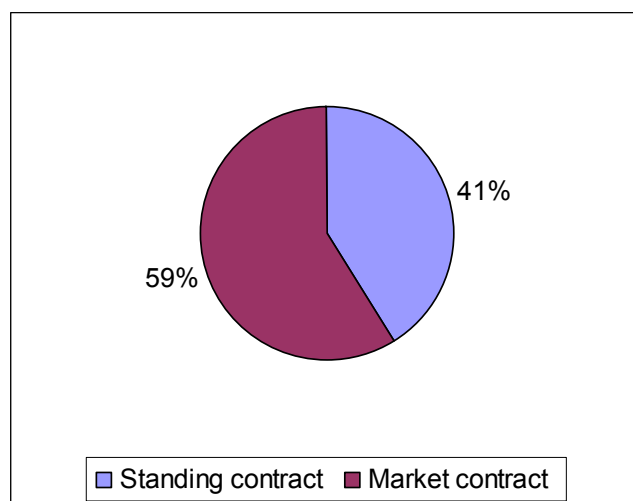
Customers' positive attitudes towards FRC are reflected in a high level of switching. By the end of 2006, approximately 60 per cent of domestic or small business electricity customers in Victoria and approximately 59 per cent of gas customers had entered into a market contract (Figures 4.7 and 4.8 below).

**Figure 4.7 Proportion of electricity customers on market and standing offer/deemed contracts**



Source: AEMC retailer data template.

**Figure 4.8**      **Proportion of gas customers on market and standing offer/deemed contracts**



Source: AEMC retailer data template.

That the large majority of customers are aware of the availability of retailer choice under FRC and consider that to be beneficial indicates that one of the necessary pre-conditions for competition to be driven by the demand side of the market is met; namely, that customers know they can choose their retailer and that the opportunity to make this choice is viewed favourably. However, retailers will not be exposed to competitive pressure and the effectiveness of competition will be open to question unless customers participate in the competitive process by switching, or by being prepared to switch, between retailers to obtain energy products, prices and other terms and conditions that best suit their needs. The number of customers who are currently on market contracts and the high rates of switching illustrated above suggest this has not been a concern in energy retailing in Victoria to date. These matters are discussed further in Chapters 5 and 6 of the First Final Report.

### **4.3 Regulation of energy retailing in Victoria**

Victorian retail energy businesses are required to comply with specific requirements prescribed by legislation and a range of subordinate instruments such as regulations, Orders in Council, licences, codes and guidelines (together, “regulation”). These requirements affect many aspects of energy retailing, including prohibiting the retailing of energy without a licence and requiring designated retailers to offer to sell energy to customers in a specified area. The energy products and services offered by retailers must also comply with specific requirements, including the terms and conditions on which they are offered (including, for some products, the price), the way in which information about products and services is communicated to prospective customers, and minimum standards governing the way retailers may deal with customers. This section provides an overview of the regulatory requirements that are of primary relevance to the Victorian Review.

#### 4.3.1 Retail price regulation and the standing offer

Prior to the commencement of FRC, the Victorian Government expressed the view that “the protection afforded by the competitive market may not be adequate for the last group of franchise customers including domestic and small business customers”.<sup>54</sup> The Government therefore proposed that it would retain a reserve power to regulate retail prices for these customers (called prescribed customers) as a transitional measure until an effectively competitive retail market had developed.<sup>55</sup> The reserve power is contained in s 13 of the *Electricity Industry Act 2000 (Vic)* (EIA) and s 21 of the *Gas Industry Act 2001(Vic)* (GIA).

The Government has not exercised its reserve power to regulate retail energy prices since 2002. However, against the background of the reserve power it has negotiated a retail price path with the host electricity and gas retailers which provides for agreed annual movements in the average prices for services to domestic and small business customers on a standing offer contract.<sup>56</sup> For the purpose of the application of the price path, domestic and small business customers are defined as customers using 160MWh or less of electricity or 5TJ or less of gas per annum, and who are not taking supply under a market offer from any retailer.<sup>57</sup>

The current price path applies for a four year period ending 31 December 2007. The Parliament has passed amendments to the EIA and GIA to enable the Victorian Government and the host retailers to agree a price path to apply in 2008.<sup>58</sup> For the purpose of the 2008 price path, the definition of a “prescribed customer” has been limited to those customers who meet the current annual consumption thresholds but who purchase electricity or gas principally for personal, household or domestic use; that is, domestic customers.

The price path forms part of what is commonly referred to as the “consumer safety net arrangements”. The key elements of the arrangements are summarised in the following paragraphs.

The host retailer must offer to supply and sell gas or electricity (as appropriate) to customers in its previously franchised area at an approved price and on standard terms and conditions.<sup>59</sup> These offers are called “standing offer contracts”. The

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<sup>54</sup> Parliamentary Counsel, Hansard, Legislative Assembly, 4 May 2000, p. 1317.

<sup>55</sup> *Id.*

<sup>56</sup> Section 13(1) of the EIA and s 21(1) of the GIA permit the Governor in Council, by Order in Council published in the Government Gazette, to regulate the tariff payable by “prescribed customers or a class of prescribed customers.” By the Order in Council made under s 35 of the EIA (dated 11 January 2002 and gazetted in Victorian Government Gazette No. S 11, 11 January 2002), customers who consume 160 MWh or less of electricity per annum are prescribed customers. By the Order in Council made under s 42 of the GIA (dated 29 October 2002 and gazetted in Victorian Government Gazette No. S 197, 29 October 2002), customers who consumer 5TJ or less of gas per annum are prescribed customers.

<sup>57</sup> Order in Council made under s 35 of the EIA (dated 11 January 2002 and gazetted in Victorian Government Gazette No. S 11, 11 January 2002), and Order in Council made under s 42 of the GIA (dated 29 October 2002 and gazetted in Victorian Government Gazette No. S 197, 29 October 2002).

<sup>58</sup> *Energy Legislation Further Amendment Act 2007 (Vic)*.

<sup>59</sup> Section 35(1), EIA and s 42(1), GIA.

prices, terms and conditions that apply to standing offer contracts also apply to supply contracts that are deemed to exist under s 37 of the EIA and s 44 of the GIA<sup>60</sup> and under s 39 of the EIA and s 46 of the GIA.<sup>61</sup> Contracts deemed to exist under these sections are referred to in the legislation as “deemed contracts”.

The terms and conditions of the standing offer concerning disconnections, the provision of information about customer rights and entitlements, access to premises for meter reading, and confidentiality of customer information must comply with those specified by the ESC and contained in the Energy Retail Code. Any term or condition of a standing offer that is inconsistent with a term or condition specified by the ESC will be void to the extent of the inconsistency, and is deemed to be replaced by the term or condition contained in the Energy Retail Code.<sup>62</sup>

The Energy Retail Code contains a number of terms and conditions that are not specified as matters for approval by the ESC under the energy legislation. These relate to matters such as billing, credit management, contract consent and variation, the term and termination of the contract, complaints and dispute resolution, and privacy and confidentiality (together, the “minimum service standards”). It is a condition of the licences issued to host retailers that the standing offer terms and conditions must not be inconsistent with these terms and conditions.<sup>63</sup>

Each host retailer is required to publish the tariff (i.e. the price) and the terms and conditions that apply to its standing offer in the Victorian Government Gazette.<sup>64</sup> If it considers that the tariffs are unreasonable, the Government may exercise its reserve power to amend the published tariffs. To date, the Government has not exercised its reserve power for this purpose.

As the host retailers for gas and electricity in Victoria, AGL, Origin Energy and TRUenergy are each required to offer standing offer contracts to customers within their previously franchised areas. Customers are therefore able to choose between

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<sup>60</sup> Under these provisions, a customer who was a franchise customer immediately prior to 1 January 2001 (electricity) or 1 September 2001 (gas) and has not entered into a new contract with a retailer is deemed to have entered into a contract with the retailer who was supplying that customer before that date. The applicable tariffs, terms and conditions of the deemed contract are the same as those in the standing offer contract offered by that retailer. As the only retailers licensed to supply domestic and small business customers prior to 1 January and 1 September 2001 were the host retailers, AGL, Origin Energy and TRUenergy are the only retailers that are party to such contracts.

<sup>61</sup> Under these provisions, a contract is deemed to exist between a retailer supplying a premises and a customer who commences consuming energy at that premises without first having entered into a supply and sale contract with the retailer. The applicable tariffs, terms and conditions of the deemed contract are the same as those contained in the standing offer contracts offered by that retailer. These deeming provisions apply to “relevant customers”, namely, customers who consume 10TJ or less of gas or 160MWh or less of electricity per annum: Order in Council made under s 36 of the EIA (dated 11 January 2002 and gazetted in Victorian Government Gazette No. S 11, 11 January 2002), and Order in Council made under s 43 of the GIA (dated 29 October 2002 and gazetted in Victorian Government Gazette No. S 197, 29 October 2002).

<sup>62</sup> Sections 36(1) and (2), EIA and ss 43(1) and (2), GIA.

<sup>63</sup> The retail licences issued to AGL, Origin Energy and TRUenergy provide that each term or condition of the Energy Retail Code is a term or condition with which a contract for the sale of gas or electricity must not be inconsistent.

<sup>64</sup> Section 35(1)(a), EIA and s 42(1)(a), GIA.

acquiring energy at the standing offer price and under the standing offer contract terms and conditions, or moving to a market contract. Market contracts, whether offered by a host retailer or a new retailer, are also required to contain the non-price terms and conditions set out in the Energy Retail Code.

A customer who accepts a competitive market contract may subsequently revert to a standing offer contract.<sup>65</sup>

### **4.3.2 Other energy-specific regulatory obligations**

In addition to the consumer safety net arrangements discussed above, a range of other obligations regulate the manner in which businesses sell electricity and gas to domestic and small business customers in Victoria. However, not all of these are relevant to this Review. The purpose of this section is to identify other regulatory obligations that are specific to the supply of energy to these customers and which the Commission considers may affect, directly or indirectly, the effectiveness of retail competition in Victoria.

#### **4.3.2.1 Licensing**

Retailing electricity and gas in Victoria by any person is prohibited unless that person holds a licence or is otherwise exempt.<sup>66</sup> A person who contravenes this prohibition is guilty of an offence punishable by a fine.<sup>67</sup>

Any person may, by application to the ESC, apply for a licence authorising the applicant to sell gas or electricity.<sup>68</sup> To assist applicants, the ESC has published procedures and guidance notes for applications for and transfers of gas and electricity licences.<sup>69</sup> Each application must include certain minimum information about the applicant, such as the applicant's name and contact details, and a contact person on behalf of the applicant. The application must also include a statement as to how granting the licence would be consistent with the ESC's objectives as set out in s 8 of the *Essential Services Commission Act 2001* (Vic).

The ESC must not approve an application for an electricity retail licence unless it is satisfied that the applicant is financially viable and has the technical capacity to comply with the conditions of the licence.<sup>70</sup> Although the GIA does not contain an equivalent provision, the Guidance Note on licensing states that the ESC will not

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<sup>65</sup> Section 35(4A), EIA and s 42(4A), GIA.

<sup>66</sup> Section 16(1), EIA and s 22(2), GIA.

<sup>67</sup> *Id.*

<sup>68</sup> Section 18(1), EIA and s 25(1), GIA. The ESC may grant or refuse applications for retail licences under s 19, EIA and s 26(1) GIA.

<sup>69</sup> See *Procedures for applications for electricity licences and electricity licence transfers* (November 2006), *Guidance notes for applications for electricity licences and the transfer of existing electricity licences* (November 2006), *Procedures for applications for gas licences and gas licence transfers* (October 2006), and *Guidance notes for applications for gas licences and the transfer of existing gas licences* (October 2006).

<sup>70</sup> Section 19(2), EIA. The ESC does not need to be satisfied of these matters if ss 19(3) or (4), EIA apply.

grant an application for a gas retail licence unless it is satisfied of these matters.<sup>71</sup> To this end, an application must provide sufficient information to satisfy the ESC of its financial viability and technical capability.

A licence is issued for such term (if any) as decided by the ESC and specified in the licence.<sup>72</sup> At present, the retail licences issued by the ESC are for an indefinite term (subject to compliance with the terms of the licence). Once granted, the licensee must pay an annual licence fee determined by the Minister each year. The quantum of the fee is determined by reference to the number of customers each retailer has. Table 4.5 below sets out the fees payable for the year to 30 June 2007.

**Table 4.5 Victorian energy retail licence fees 2006-07**

Threshold customer base	Annual electricity licence fee	Annual gas licence fee
Restricted	N/A	\$13,000
≤1,000 customers	\$13,000	\$13,000
>1,000 and ≤50,000 customers	\$16,937	\$16,937
>50,000 and ≤100,000 customers	\$30,068	\$30,068
>100,000 customers	\$119,980	\$119,980

Source: ESC website, [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

A licence is granted subject to conditions decided by the ESC.<sup>73</sup> Without limiting the generality of this power, the energy legislation identifies specific conditions that may be included.<sup>74</sup> Some of these conditions which are included in the retail licences issued to Victorian retailers include:

- requiring the licensee to enter into agreements on specified terms or on terms of a specified type;
- the requirement to observe specified Orders in Council, industry codes, standards, rule and guidelines (with such modifications or exemptions as may be specified by the ESC); and
- requiring the licensee to develop, issue and comply with customer-related standards, procedures, policies and practices (including with respect to the payment of compensation to customers).

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<sup>71</sup> Essential Services Commission, *Guideline notes for applications for gas licences and the transfer of existing gas licences*, October 2006, p. 1.

<sup>72</sup> Section 20(1), EIA and s 28(1), GIA.

<sup>73</sup> STET.

<sup>74</sup> Section 21, EIA and s 29, GIA.



#### 4.3.2.2 Obligation to offer to supply and sell

A retail energy licence is deemed by legislation to contain a condition requiring the licensee to offer to supply and sell energy to domestic or small business customers.<sup>75</sup> However, in practice only the host retailers are subject to this obligation to offer to supply and sell.

As required by s 35(1) of the EIA and s 42(1) of the GIA, the licence issued to each retailer authorised to retail electricity or gas to domestic or small business customers in Victoria is required to offer a standing offer contract to this class of customers. This obligation constitutes the obligation to offer to supply and sell electricity or gas (as appropriate). However, each licence further provides that this obligation does not apply to the extent nominated by the ESC. The Commission understands that the ESC has written to all non-host retailers advising that they are not bound by the obligation to offer to supply and sell. In practice, this means that the obligation applies only to the host retailers.

#### 4.3.2.3 Financial hardship policies

In March 2005, the Victorian Government established a Committee of Inquiry into the Financial Hardship of Energy Consumers (Committee) to provide advice on key principles, policies and programs designed to mitigate energy consumer hardship. The Committee was asked to “assess the impact on consumer hardship of the policies and practices of all energy retailers, Government departments and agencies, and financial counsellors and welfare agencies.”<sup>76</sup>

The Committee found that while the existing framework, mechanisms and policies used to assess energy customers experiencing financial hardship were broadly suitable, some deficiencies existed in the delivery of assistance. The opportunities to improve the quality of assistance were reflected in 20 recommendations set out in the Committee’s final report.

The Government accepted 19 of the Committee’s recommendations, including the recommendation that retailers adopt and publish a Best Practice Hardship Policy.<sup>77</sup> To implement this recommendation, legislative amendments were passed requiring retailers to develop, publish and implement financial hardship policies and to submit them to the ESC for approval.<sup>78</sup>

The energy legislation requires a financial hardship policy to include:

- flexible payment options for payment of bills;

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<sup>75</sup> Section 35(1), EIA and s 42(1), GIA.

<sup>76</sup> Committee of Inquiry into the Financial Hardship of Energy Consumers, *Summary Report*, September 2005, p. 4.

<sup>77</sup> *Government Response to the Hardship Inquiry*, p. 3.

<sup>78</sup> Section 43, EIA and s 48G, GIA.

- provision for the auditing of a domestic customer's electricity or gas usage (whether wholly or partly at the expense of the retailer);
- flexible options for the purpose of supply of replacement electricity or gas appliances designed for domestic use from the retailer or a third party nominated by the retailers; and
- processes for the early response by both the retailer and domestic customers to electricity or gas bill payment difficulties.

Each retailer submits its financial hardship policy to the ESC, who may approve the policy if it "considers it appropriate."<sup>79</sup> In April 2007, the ESC published *Guideline No 21: Energy Retailer's Financial Hardship Policies* (Financial Hardship Guideline) to assist retailers in preparing financial hardship policies. The objective of the Financial Hardship Guideline is to provide guidance to retailers, domestic customers and other stakeholders about the ESC's approach to approving financial hardship policies.<sup>80</sup>

The Financial Hardship Guideline provides that the ESC expects that a financial hardship policy will, amongst other things:

- reflect the notion that a domestic customer in financial hardship is one that has the intention but not the capacity to make a payment within the timeframe required by the retailer's usual payment terms;
- provide details of the processes and criteria to enable a domestic customer in financial hardship to identify themselves to, be referred to, or be identified by the retailer, and the processes and criteria that will apply to assess the options available to that domestic customer; and
- offer fair and reasonable payment options to the domestic customer.

Retailers must publish the details of their financial hardship policies on their websites in a way that is easy for customers to access, and must provide details of the policy to a customer or financial counsellor on request. Financial hardship policies must be subject to periodic review. Requests to the ESC for approval of a new or amended policy must be accompanied by a statement as to the nature, impact and reason for the change.

#### **4.3.2.4 Retailer of last resort**

Electricity and gas retailers in Victoria are subject to a licence condition requiring them, in certain circumstances, to supply or sell electricity or gas to certain customers

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<sup>79</sup> Section 45(1), EIA and s 48I(1), GIA.

<sup>80</sup> Essential Services Commission, *Final Decision: Energy Retailers' Financial Hardship Policies*, April 2007, p. 1.

of another retailer on tariffs, terms and conditions approved by the ESC.<sup>81</sup> While this condition is contained in the licences issued to all retailers, only AGL, Origin Energy and TRUenergy have been required to comply with it, thereby rendering each host retailer the “retailer of last resort” (RoLR) for their respective franchise areas. Presently, new retailers are not subject to any RoLR obligations.

The circumstances in which a RoLR is required to service another licensee’s customer base is limited by legislation, commencing when:<sup>82</sup>

- the licensee’s retail licence is revoked; or
- in the case of electricity, the right of the licensee to acquire electricity from the wholesale electricity market is suspended or terminated; or,
- in the gas of case, the licensee has been deregistered as a market participant in the category of retailer under the Market and System Operations (MSO) Rules after a notice of suspension is issued to the licensee by VENCorp under those Rules.

In the event of a failure of a new (i.e. non-host) retailer, the RoLR will be the host retailer for the area in which the customer is located. Where the failed retailer is an electricity host retailer, the remaining host retailers will be assigned responsibility to provide RoLR services and allocated customers on the basis of the Transmission Node Identifier (the code identifying the relevant transmission node) and market share. If the failed retailer is a host gas retailer, the RoLR services will be shared between the remaining host retailers. Because each gas distribution network area in Victoria is serviced by two retailers, customers will be allocated to the other host retailer for that distribution area.<sup>83</sup>

Where a RoLR event occurs, the energy legislation deems a contract to exist between the RoLR and each affected customer.<sup>84</sup> The tariffs, terms and conditions of that contract are the same as those contained in the RoLR’s standing offer.<sup>85</sup> The RoLR’s obligation to supply or sell continues for no longer than 3 months<sup>86</sup> unless the ESC requires the RoLR to continue to supply or sell to the affected customers, however, any supply or sale takes place at tariffs, and on terms and conditions determined by the RoLR.<sup>87</sup>

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<sup>81</sup> Section 47D, EIA and s 51D, GIA. The obligation to supply or sell only exists in relation to “relevant customers”; that is, domestic or small business customers who consume 160MWh or less of electricity or 10TJ or less of gas per annum.

<sup>82</sup> Section 49D(5), EIA, and s 51D(5), GIA.

<sup>83</sup> Essential Services Commission, *Energy Retailer of Last Resort: Final Decision*, February 2006, pp. 1-2.

<sup>84</sup> Section 49E(5), EIA and s 51E(5), GIA.

<sup>85</sup> Essential Services Commission, *Energy Retailer of Last Resort: Final Decision*, February 2006, p. 3.

<sup>86</sup> Section 49D(6), EIA and s 51D(6), GIA.

<sup>87</sup> Sections 49E(6) and (7), EIA and ss 51E(6) and (7), GIA.

#### 4.3.2.5 Credit support requirements

One important factor in ensuring the stability and financial integrity of the NEM and the wholesale gas market in Victoria is maintaining adequate prudential requirements to manage the financial risks incurred by market participants and minimise the effect on the market of a payment default. In the case of the NEM, the prudential requirements are administered by NEMMCO and, in relation to the wholesale gas market, by VENCORP. Retailers may also be required to provide credit support facilities in favour of distribution businesses to manage the distributor's risk exposure to the non-payment of its distribution charges. The purpose of this section is to provide an overview of these three types of credit support arrangements as they apply to retailers as background to the Commission's analysis in the successive chapters of the First Final Report.

In relation to the NEM, the primary prudential requirement that retailers must comply with is the obligation to provide credit support to NEMMCO. The bulk of credit support is provided in the form of bank guarantees.<sup>88</sup>

The amount of credit support to be provided is calculated by NEMMCO in accordance with the National Electricity Rules.<sup>89</sup> NEMMCO reassesses the amount of credit support required at least quarterly and more often if there are changed circumstances.<sup>90</sup> For example, in June 2007 NEMMCO conducted an unscheduled review and adjusted the amount of credit support required from some participant segments in response to changes in market conditions.

NEMMCO also reviews the credit support arrangements, trading limits (a proportion of the retailer's maximum credit limit) and financial exposure of market participants on a daily basis. Where a market participant exceeds its trading limit, the Rules require the participant to immediately provide cash, a bank guarantee or a reallocation to cover the excess.

Similarly, retailers who wish to participate in the Victorian wholesale gas market are required to satisfy prudential requirements. The MSO Rules require security to be provided in a form that is acceptable to VENCORP<sup>91</sup> and that can be called upon in certain circumstances (e.g. in the event of a payment default).

Each retailer must determine the impact its trading activities will have on its exposure to the market, and may provide a security that is greater than the minimum security required under the MSO Rules to minimise the possibility of incurring a margin call.<sup>92</sup> Once the retailer has provided a security acceptable to VENCORP,

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<sup>88</sup> NEMMCO, *Australia's National Electricity Market: Trading Arrangements in the NEM*, 2004, pp. 14-15.

<sup>89</sup> This amount, defined as the maximum credit limit (MCL), is calculated on the basis of a "reasonable worst case" estimate of the aggregate payments (after reallocation) to be made by the market participant to NEMMCO over a 42 day trading period, to a probability level that the estimate would be not be exceeded more than once in 48 months: clause 3.3.8, National Electricity Rules. In accordance with Schedule 3.3, NEMMCO may calculate the MCL on the basis of a shorter trading period upon written request from the market participant.

<sup>90</sup> NEMMCO, *NEM Settlement Prudential Supervision Process*, Version No. 11, 12 July 2007, p. 3.

<sup>91</sup> Clause 3.7.3, MSO Rules.

<sup>92</sup> Clause 3.7.4(d), MSO Rules.

VENCorp sets the retailer's trading limit at an amount that is not less than their minimum exposure or a level set by VENC Corp (currently 85% of their security).<sup>93</sup>

VENCorp undertakes daily monitoring of each retailer's exposure to the market and must issue a margin call if any retailer's exposure exceeds its trading limit. When a margin call has been issued, the retailer has a limited time to bring its exposure below its trading limit by either making a prepayment or increasing its security.

A retailer may also be required to provide credit support pursuant to the use of system agreements it enters into with electricity or gas distribution network operators, the quantum of which is calculated in accordance with the terms and conditions of the distributor's access arrangement. The default terms and conditions applicable to credit support are largely standardised as between gas and electricity distributors in Victoria.

In the Issues Paper, the Commission noted that one of the matters raised in submissions on the Draft Statement of Approach was that the existing regulatory framework (including existing price oversight arrangements) may be affecting the development of competition in energy retailing in Victoria.<sup>94</sup> The First Final Report now turns to consider the extent of retailer rivalry, including whether the current regulatory framework is having an impact on competition between Victorian energy retailers.

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<sup>93</sup> Clause 3.7.8(c), MSO Rules.

<sup>94</sup> Australian Energy Market Commission, *Review of the Effectiveness of Competition in Gas and Electricity Retail Markets – Issues Paper*, 1 June 2007, p. 23.

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## 5 Retailer Rivalry

This chapter considers the first of the Commission's analytical strands: rivalry between retailers. Independent rivalry between suppliers is the cornerstone of effective competition and arguably the most important of the three analytical strands. While effective competition requires both rivalrous conduct between retailers seeking to provide attractive offers to customers and informed and active customers making choices that best meet their wants or needs, retailer rivalry can be an important determinant of customer participation in the market. Retailers' marketing and information provision can help to increase consumer interest in energy products, to better inform consumers about their options and to overcome actual or perceived search and switching costs. Further, although the threat of entry can be an important, and even decisive, discipline on the conduct of market participants, effective competition is still possible without the threat of entry, as long as there is sufficient rivalry between established suppliers.

In Victoria, retail energy customers were previously supplied by government monopolies. As discussed in Chapter 4, host retailers are required to provide a standing offer and in the absence of making an active choice about their energy supply options, customers in each retailer's franchise area will continue to be supplied by their host retailer pursuant to these arrangements. The standing offer and deemed customer contracts are important influences on all aspects of retailer rivalry, particularly in the light of the characteristics of energy demand discussed in Chapter 4:

- the standing offer currently provides a benchmark for both the level and structure of retail price offers; and
- new and established retailers seeking to win customers away from their existing supplier must engage in marketing activities and provide consumers with information and offers which overcome inertia and motivate them to switch retailer.

While many customers may have a low level of interest in retail energy products, there are customers – “switchers” – who will switch to another product or supplier in the event of a price increase or equivalent deterioration in quality or service. As discussed in Chapter 3, the presence of a sufficient number of switchers constrains the pricing, service and quality decisions of retailers. Therefore, as long as retailers can motivate enough consumers to engage with the competitive market and switch in favour of better offers, and retailers cannot discriminate in their marketing and the offers they make to switchers compared to non-switchers, all customers will benefit from retailer rivalry.

As noted in Chapter 4, 60 per cent of Victorian energy customers have already demonstrated their willingness to switch energy retailers. However, it is necessary

to consider the extent to which retailers are able to identify and discriminate against non-switchers in their marketing.<sup>95</sup>

This chapter examines the nature of rivalry between energy retailers in Victoria and the extent to which they compete for particular groups of customers. More specifically, this section considers:

- the nature of price rivalry between energy retailers for the supply of electricity and gas;
- the extent of product and service differentiation and non-price rivalry between retailers;
- the nature of retail marketing of electricity and gas contracts;
- the extent to which retailers are providing information to customers to better enable them to make informed decisions in relation to their energy supply; and
- the prevalence of mis-selling practices among retailers such as high pressure selling or the provision of misleading information to potential customers.

## 5.1 Price rivalry

In an effectively competitive market, suppliers will seek to retain or grow their market share by offering products that meet the needs of their customers and those of prospective customers. In markets involving the sale of relatively homogenous products, rivalry will often be based on price. In the case of energy, the Consumer Survey indicates that price is the most important influence on customer choice. Over time, retailer rivalry will ensure that prices will be driven toward the level of efficient costs.

When assessing the extent to which retailers are engaged in price-based competition, it is relevant to consider the role of the standing offer tariff. The standing offer forms a benchmark for the marketing of price offers and retailers set their prices by reference to it, rather than by reference to the prices of their competitors. In the early stages of contestability such comparisons can be of great benefit as the relevant decision for most customers is whether to move from the standing offer to a market contract. In a competitive market, prices emerge through the process of inter-firm rivalry and market discovery. The standing offer tariff bears no necessary relationship to the competitive price and can potentially limit the extent of price rivalry. Notwithstanding, Victorian energy retailers have continued to price by reference to the standing offer, primarily because it allows for simple comparisons to be made in an environment where customers want information that is easy to understand.

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<sup>95</sup> For discrimination to be effective, retailers need to be able to both identify those customers least likely to switch and be able to prevent arbitrage between customer groups. The latter condition is satisfied for retail energy products because they are distributed to and consumed at specified customer premises, with no opportunity for re-selling.



In assessing the extent to which retailers are competing on the basis of price, it is relevant to consider the extent to which discounts to the standing offer tariff are being offered and the variation in discounts between retailers. However, it is also relevant to consider the extent to which the level and structure of the standing offer tariff reflects the cost of service. Where the standing offer tariff does not change in line with an increase in the cost of supply, discounts available to market contract customers may diminish over time as retailers attempt to maintain their margins. Alternatively, retailers may cease actively marketing to prospective customers. Where the structure of the standing offer tariff does not reflect the cost of service to some customer groups, retailers may also be inhibited from offering more efficient tariff structures that may improve outcomes for some customers.

This section considers the extent to which energy retailers are competing for small customers on the basis of price. In undertaking this analysis, the Commission assessed a number of energy market offers available to both domestic and small business customers by reference to information contained on retailers' websites as at 1 October 2007. Details of the market offers available to domestic and small business customers (excluding green offers<sup>96</sup>) examined by the Commission are set out in Appendix C.<sup>97</sup> This table outlines the price and non-price features of each of the market offers the Commission considered, as well as the discount from the standing offer tariff offered under each contract. The results of the Commission's analysis is set out in sections 5.1.1 and 5.1.2 below. The Commission notes that it has not considered every market contract available at the time its analysis was undertaken and that some retailers had elected to scale back their marketing activities because of higher wholesale prices. In light of these factors, the Commission's analysis is only indicative of the level of price rivalry between retailers at that time.

### **5.1.1 Market offers for domestic customers**

Most retailers have developed at least one generic market contract that is available to domestic customers with different consumption profiles across Victoria.<sup>98</sup> All 13 retailers offered electricity market contracts and six offered market contracts for the supply of gas.<sup>99</sup> Market offers for gas are most frequently offered in conjunction with the supply of electricity under a single contract type (i.e. customers must obtain both their electricity and gas supply from a single retailer in order to switch to a gas market contract and must have the same type of contract for both electricity and gas).<sup>100</sup>

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<sup>96</sup> Green Energy offers are discussed separately in Section 5.2.1 below.

<sup>97</sup> At the time the Commission undertook its analysis, information about Red Energy's electricity market offers was unavailable due to an upgrade to the Red Energy website.

<sup>98</sup> Although tariffs differ between distribution regions, the discounts available relative to the standing offer are consistent across each region.

<sup>99</sup> Red Energy, who began marketing and selling gas to domestic and small business customers in September 2007, is now the seventh gas retailer in Victoria.

<sup>100</sup> The Commission notes that some gas only products do exist. For example, the "Go Easy" and "Go for More" product ranges offered by TRUenergy allow customers to choose gas only, electricity only, or a combined gas and electricity product: TRUenergy, submission to the First Draft Report, p. 3.

Some retailers offer contracts for a fixed term of two to three years, with associated termination fees of \$40 to \$95. All but three retailers offer contracts with no fixed term and no termination fee. With the exception of Simply Energy and Powerdirect, all retailers offer market contracts with the same tariff structure as the standing offer, with discounts applied either to the customer's total energy bill or to the variable consumption charge.<sup>101</sup> Of the 11 retailers whose market contracts were examined.

- five retailers offer at least one electricity market contract with rates at a discount to the standing offer, ranging from 2 per cent to 7 per cent, although for four of these offers the customer is required to enter into a contract of two or three years duration in order to obtain the discount;
- four retailers offer discounts for prompt payment of energy bills, where the discount ranges from 2 per cent to 5 per cent off the customer's annual energy bill;
- three retailers offer other up-front price discounts ranging from \$25 to \$60; and
- one retailer offers a discount off the purchase price of other products or services sold in its energy stores.

Taking these direct price benefits into account, the discounts available under electricity market contracts ranged up to 10 per cent off the standing offer price, with almost all contracts incorporating a price discount of some kind. Discounts are offered by both host and new retailers, with the largest discounts offered by Click and Country Energy, primarily due to the offer of direct monetary rebates in combination with price discounts or discounts for prompt payment.

Three retailers (Origin Energy, Simply Energy and Victoria Electricity) did not have any offers advertised at a discount to the standing offer.<sup>102</sup> As noted above, this is likely to be reflective of the responses of retailers to market conditions at the time. The Commission notes that the retailer who had temporarily ceased actively marketing to retail energy customers has recommenced these activities.<sup>103</sup>

There are fewer market contracts available for electricity and gas supply than there are for the supply of electricity only. Of the six retailers that offer both electricity and gas market contracts, only three (AGL, Australian Power & Gas and TRUenergy) currently offer gas at a discount to the standing offer, the available discounts ranging from 3-6 per cent. These retailers offer the same percentage price discounts for both their electricity and gas market offers. The lower percentage discounts provided under gas market contracts, relative to electricity contracts in general, may reflect the

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<sup>101</sup> Simply Energy and Powerdirect both offer a tariff with a fixed charge and a single variable consumption charge.

<sup>102</sup> Victoria Electricity note that the pricing and charges presented in their Product Information Statements are for their standard default prices only. Fixed term contracts and discounts from the default rates may be available. Simply Energy also offers a single rate contract whereby the rate is fixed for the 2-year term of the contract.

<sup>103</sup> Simply Energy, submission to the First Draft Report, p. 1. Origin Energy also commented on this phenomenon: Origin Energy, submission to the First Draft Report, p. 3.

lower margins available to retailers from the supply of gas given the current standing offer prices.<sup>104</sup>

The price discounts available under both electricity and gas market contracts appear largely consistent with those offered in 2003 and 2006. The 2004 ESC Review revealed that discounts of up to 10 per cent were available under electricity market contracts and discounts of up to 6 per cent were available under gas market contracts at that time.<sup>105</sup> Further analysis undertaken by the ESC in 2006 shows that the available price discounts offered by retailers under peak and off-peak electricity market contracts were up to 8 per cent in the Origin Energy (Powercor) distribution area, up to 10 per cent in the AGL distribution area and up to 13 per cent in the TRUenergy distribution area.<sup>106</sup>

### 5.1.2 Market offers for small business customers

As is the case for domestic customers, those retailers that target small business customers have at least one market contract that is available to a variety of small businesses across Victoria.<sup>107</sup> At least two of the retailers that publish information in relation to their small business offers (TRUenergy and Victoria Electricity) offer contracts for the supply of both electricity and gas.

Three of the seven retailers that publish information in relation to their small business offers indicate that their offers are for a fixed term of two or three years with associated termination fees of between \$95 and \$110. All but one retailer (Victoria Electricity) offer some form of price discount to the standing offer, although Victoria Electricity only publishes its default tariffs and may offer discounts to customers through their direct marketing initiatives. Of the six retailers that do offer price discounts:

- five offer at least one electricity market contract with rates at a discount to the standing offer, ranging from 2 per cent to 10 per cent (only two of these retailers require customers to enter into a contract of two or three years duration in order to obtain the discount);

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<sup>104</sup> See Chapter 8. The fact that gas contracts are predominantly offered in combination with electricity supply likely reflects the lower margins that are available for gas supply. Such margins may not be sufficient for retailers to recover the stand alone marketing cost for gas only contracts.

<sup>105</sup> Essential Services Commission, *Special Investigation: Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity: Background Report*, June 2004, p. 85. The Commission notes that a larger range of price discounts appeared to be available to customers in 2003. For example, some retailers offered large direct monetary rebates for the transfer of both fuels and some offered one month's free energy 12 months after transfer. See further analysis on pages 131-134 of the ESC's report.

<sup>106</sup> The available discounts available under peak only electricity market contracts were slightly larger: up to 9 per cent in the Origin Energy (Powercor) distribution area, up to 15 per cent in the AGL distribution area and up to 14 per cent in the TRUenergy distribution area: Essential Services Commission, *Energy Retail Businesses: Comparative Performance Report for the 2005-06 Financial Year*, November 2006, pp. 11-15.

<sup>107</sup> Note that tariffs differ between distribution regions. For some retailers, the discounts available relative to the standing offer are consistent across each region whereas others vary their discounts by region.

- two retailers offer discounts for prompt payment of energy bills, where the discount ranges from 3 per cent to 5 per cent off the customer's annual energy bill; and
- two offer other up-front price discounts ranging from \$50 (payable over 2 years) to \$60.

Taking these direct price offers into account, discounts of up to 10 per cent off the standing offer price were available under the electricity and gas market contracts. Unlike offers for residential customers, the retailers that appear to offer the largest discounts to small business customers are Origin Energy and TRUenergy. However, the Commission notes that the sample of offers it reviewed is limited and larger discounts may be provided by other retailers. Data published by the ESC in 2006 suggests that price discounts of up to 18 per cent off the standing offer were being offered by Powerdirect, Momentum Energy and Victoria Electricity in some distribution areas at the time.<sup>108</sup>

The Commission notes that the tariff structures adopted by retailers for their small business market offers appear to be slightly more varied than the contracts offered to domestic customers. Some retailers, for example Origin Energy and TRUenergy, offer percentage price discounts from standing offer rates whereas others such as AGL and Powerdirect apply different percentage up-lifts or discounts from one or more variable consumption rates.

As was the case for domestic customers, the price discounts available to small business customers appear largely consistent with those offered in 2003. The 2004 ESC Review found that discounts of up to 6 to 10 per cent were available to small business customers under electricity market contracts and discounts of up to 5 per cent were available under gas market contracts at that time.<sup>109</sup> Price discounts appear to be lower than those offered in 2006 although this may reflect retailers' views regarding the future cost of wholesale energy.

### 5.1.3 Tariff Design

With the exception of Simply Energy and Powerdirect, most retailers structure their domestic market offers on the same basis as the standing offer, with discounts applied to either the customer's total bill or energy usage charge.<sup>110</sup> The lack of differentiation in tariffs is relevant from a competition perspective. On the one hand, the application of a standard tariff structure allows for a simple comparison of offers. On the other, the application of different pricing structures would improve choice for

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<sup>108</sup> Essential Services Commission, *Energy Retail Businesses: Comparative Performance Report for the 2005-06 Financial Year*, November 2006, pp. 15-16.

<sup>109</sup> Essential Services Commission, *Special Investigation: Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity*, June 2004, p. 85.

<sup>110</sup> Standing offers for electricity in each region of Victoria are comprised of a fixed charge and variable consumption charge. In some regions a two-step consumption charge is applied. Peak and off-peak standing offers have a lower consumption charge applied for all energy consumed during off-peak times.

customers<sup>111</sup> and allow tariffs to more accurately reflect the cost of serving different types of customers. In the UK, retailers are now offering a greater range of tariff products that have proved popular in the market. These include green, fixed price and online deals, and retailers are starting to offer products that reward customers for saving energy.<sup>112</sup>

Comments made by retailers suggest that the lack of differentiation in tariff structures is in large part due to the existence of the standing offer. As part of the Retailer Survey, retailers were asked to rate, on a scale of 1 to 10, the extent to which the standing offer limited their ability to introduce a greater range of innovative products or offer more innovative pricing structures. Nine of the thirteen electricity retailers and three of the six gas retailers that responded to the survey gave a rating of six or more, where a rating of ten was considered “extremely limiting”.<sup>113</sup> TRUenergy, in its submission to the First Draft Report, stated that:<sup>114</sup>

“... whilst standing offer tariffs remain, simplicity is expressed in the form of consistency with the standing offer tariff (i.e. products offered as a discount to that tariff), rather than in the form of a simplified tariff structure.”

In interviews conducted as part of the Retailer Survey, retailers observed that the standing offer forms a benchmark against which market offers can be compared. Two retailers noted that they had offered contracts with a different pricing structure but had withdrawn them given customers’ desire to receive a simple comparison of how much they will save under a market contract relative to the standing offer.<sup>115</sup> As noted by one new retailer:<sup>116</sup>

“It’s very hard to have a pitch that gets around the you know, 5% [discount off the standing offer tariff]. And we’ve seen customers turn away from us on the basis that we’ve had them on ... a daily charge with a lower energy cost ... it’s the standing tariffs or the base level tariffs that are creating that effect in the market.”

Submissions to the First Draft Report from a number of consumer advocacy groups viewed the role of the standing offer price as a benchmark or a “price to beat”

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111 The Consumer Action Law Centre took issue with this statement, submitting that the Commission misunderstands the information consumers need to make decisions about their best interests: submission to the First Draft Report, p. 8.

112 Ofgem, *Domestic Retail Market Report*, June 1007, p. 12.

113 Host retailers gave higher ratings than new retailers. The average rating given by host electricity retailers was 8 and new retailers was 6. The average rating given by host gas retailers was 8 and new gas retailers was 4: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 60.

114 TRUenergy, submission to the First Draft Report, p. 3. A similar view was expressed by Origin Energy in its submission to the First Draft Report (p. 2).

115 Retailers were asked what price information they believed to be most important to their customers when they are choosing their preferred supplier. Of the 12 retailers that responded to this question, eight noted that customers preferred comparisons of potential savings. Retailer Survey.

116 Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 15.

favourably, submitting that this facilitates competition and therefore that retail price regulation should be retained.<sup>117</sup> However, as discussed further in Chapter 7 and in the Second Draft Report, maintaining a benchmark price can be detrimental to the development of competition in the longer term if it facilitates price coordination and discourages discounting.

The preference to use the standing offer tariff as the benchmark for competitive pricing may also reduce the incentive and ability for retailers to develop and offer more innovative price structures, particularly where the standing offer does not reflect the cost of service to a proportion of customers.<sup>118</sup> Some retailers noted that if the standing offer was removed, competition would be more heavily focused on comparisons against competitors' offers<sup>119</sup> and that for some customers, market offers were likely to become more cost reflective.<sup>120</sup> Similarly, the Energy Supply Association of Australia (ESAA) submitted that removing retail price regulation would remove distortions to price signals for efficient investment in new energy supply and demand side management.<sup>121</sup>

During interviews with the retailers, some noted that further product innovation would likely develop as regulation is reduced:<sup>122</sup>

“There is an ongoing review of products in the market and how these products meet customer needs and demands. We expect that as the market further matures and as regulation in respect of market contracts is reduced, there will be significant product innovation.”

Similar views were expressed by retailers in their submissions to the First Draft Report. Origin Energy observed that the removal of price regulation in the Queensland gas market has resulted in different pricing approaches and associated products.<sup>123</sup> Implicit in Origin Energy's submission is that similar innovations would be expected if retail price regulation was removed in Victoria. The esaa submitted that retaining retail price regulation would:<sup>124</sup>

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<sup>117</sup> See, for example, the submissions to the First Draft Report from Alternative Technology Association (p. 2); Consumer Action Law Centre (p. 8); Public Interest Advocacy Centre (p. 2); St Vincent de Paul (p. 3); Victorian Council of Social Service (p. 3). The Commission notes that similar positions were put in submission to the Issues Paper: see, for example, Consumer Action Law Centre (p. 15); Consumer Utilities Advocacy Centre (p. 9); St Vincent de Paul (p. 4); Victorian Council of Social Service (pp. 7-8). Further discussion about the relevance of tariff structure for demand-side behaviour is contained in Chapter 6 of the First Final Report.

<sup>118</sup> See discussion in Chapter 8.

<sup>119</sup> Origin Energy, submission to the First Draft Report, p. 2; Simply Energy, submission to the First Draft Report, p. 2.

<sup>120</sup> Simply Energy, submission to the First Draft Report, p. 3.

<sup>121</sup> Energy Supply Association of Australia, submission to the First Draft Report, p. 2.

<sup>122</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 16.

<sup>123</sup> Origin Energy, submission to the First Draft Report, p. 2.

<sup>124</sup> Energy Supply Association of Australia, submission to the First Draft Report, p. 2.

“...limit competition for lower priced and more innovative services by providing a target price for retailers which they need only marginally undercut to attract business”.

As noted above, evidence of tariff innovation following the removal of retail price regulation is observable in the UK. In response to customer demand, retailers introduced price guarantee deals (including fixed price, capped price and tracker deals), online tariffs that offer customers savings for managing their account online, and green tariffs, which offer customers options to reduce or offset their carbon footprint.<sup>125</sup>

While there is evidence of Victorian energy retailers offering discounts against the standing offer tariff, there are indications that the presence of the standing offer has the potential to dampen price competition by virtue of being the relatively high point of reference for market price offers rather than the market prices of rival retailers. Simply Energy, for example, noted that the reference point provided by the standing offer tariff “does not necessarily reflect market conditions.”<sup>126</sup> Origin Energy submitted a similar view, noting:<sup>127</sup>

“... there is no guarantee that the standard or benchmark price is the best for consumer, or the most efficient.”

To the extent that the standing offer tariff fails to reflect the rising costs of energy supply, falling profit margins may impact adversely on the scope for price competition and the viability of energy retailers. Origin Energy noted that most retailers choose to limit their general marketing and discounting activity during periods of wholesale price uncertainty, particularly where the regulated price is insensitive to real market changes. It further observed that, at the time the Commission undertook its initial assessment of competition:<sup>128</sup>

“wholesale prices were both high and very volatile, with a good deal of uncertainty about the direction of future prices over the length of any retail market contracts.”

The results of the Commission’s analysis indicates there is a relatively strong degree of price rivalry between retailers for both domestic and small business customers. Both host and new retailers are competing for customers by offering discounts from the standing offer price. When all types of price offers are taken into account, available discounts off the standing offer price range from up to 10 per cent for electricity market contracts and up to 6 per cent for gas market contracts for both domestic and small business customers. Although some gas contracts are available as single fuel contracts, gas market contracts are predominantly available as part of a dual fuel offer, which may reflect lower margins available under the gas standing offer. Retailers do not appear to distinguish between different types of customers

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<sup>125</sup> Ofgem, *Domestic Retail Market Report*, June 1007, pp. 12-15.

<sup>126</sup> Simply Energy, submission to the First Draft Report, p. 2.

<sup>127</sup> *Ibid*, p. 2.

<sup>128</sup> *Ibid*, p. 3.

when making discounted offers, with most offers available to all types of customers regardless of location or consumption level. While some retailers appeared not to be advertising any offers at a discount to the standing offer at the time the Commission undertook its analysis, particularly for domestic customers, this appears to have reflected changes in supply costs relative to the standing offer price.

## 5.2 Non-price rivalry

In addition to discounts from the standing offer, retailers may compete for customers by offering non-price benefits. Non-price benefits are those benefits attached to market offers that do not constitute a direct monetary rebate (i.e. benefits other than discounts from energy supply charges or specified monetary rebates).

Retailers offer non-price benefits in an effort to differentiate their offers from those of their rivals and to attract those customers for whom a price discount is not sufficient encouragement to switch. For some customers, the offer of physical products or other less tangible benefits such as improved environmental outcomes or community support may be a greater, or an additional, inducement for switching to a market contract with a different retailer than simple discounts from the standing offer price. Another aspect of non-price benefits is customer service. However, the evidence reviewed by the Commission indicates that in the majority of instances, customer service is more important for retaining customers than acquiring them.

The Commission notes that there are two main types of non-price benefits offered by retailers: green energy and other non-price benefits. This section considers these benefits in turn.

### 5.2.1 Green energy

The most significant non-price benefit provided by all retailers in Victoria is the offer of “green energy” contracts (i.e. contracts under which a specified proportion of electricity is obtained from renewable energy sources such as solar or wind farms). These contracts are generally offered at a price premium to the standing offer and have largely developed in response to customer demand for environmentally friendly supply options. Indeed, a significant proportion of the customers surveyed in the Consumer Survey noted that the offer of green energy contracts was one of the main reasons for having switched to a market contract.<sup>129</sup>

There are two different types of green energy contracts: accredited GreenPower and other green energy products. Contracts referred to as “GreenPower” are those accredited by the National GreenPower Accreditation Program. To be endorsed as

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<sup>129</sup> Of those domestic customers surveyed that had switched to a market contract, 14 per cent said they had switched due to the offer of green energy. Around 10 per cent of small business customers that had switched indicated that green energy was one of the main reasons for switching: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p.44. As at June 2007, 228,389 residential customers were supplied under GreenPower accredited market offers, for whom GreenPower sales reached 43,640 MWh for the quarter ended 30 June 2007: GreenPower e-bulletin, Issue 22: August 2007 at [www.greenpower.gov.au](http://www.greenpower.gov.au).



GreenPower, electricity must be derived from renewable energy sources that meet strict environmental standards from facilities built after January 1997. Retailers that supply electricity sourced from renewable energy facilities built prior to 1997 may not use the GreenPower logo but may still advertise their products as “green”.<sup>130</sup>

Retailers offer a range of green products comprising different proportions of electricity derived from renewable energy sources, from 10 per cent up to 100 per cent GreenPower, with charges increasing with the proportion of renewable energy used. Some retailers currently offer low proportions of GreenPower at no additional cost to the standing offer, although most impose a fixed or variable consumption charge for contracts involving more than 20 per cent GreenPower as shown in Table 5.1 below.

**Table 5.1 Charges for accredited GreenPower**

Retailer <sup>1</sup>	Average estimated annual charge per proportion of accredited GreenPower			
	10%	20% - 25%	50% - 75%	100%
AGL	\$52	\$52		\$358 <sup>2</sup>
Click		\$0		
Jackgreen	\$0	\$57	\$115	\$229
TRUenergy	0/\$33	\$65	\$130	\$263

Source: Retailer websites.

Notes: (1) Other retailers including Australian Power & Gas, Origin Energy, and Victoria Electricity also offer a range of GreenPower products, although the specific charge attached to these products is not clear from the information on these retailers’ websites. (2) Annual charge based on annual consumption of 6,500 kWh.

While GreenPower products are comparable in terms of the proportion of renewable energy required to be purchased by the retailer, comparing the charges associated with such offers is less straightforward. Some retailers offer green energy at a fixed charge whereas others impose a variable charge on the basis of consumption. Some retailers offer green energy at no greater cost than the standing offer price but do not provide the customer with prompt payment or other discounts offered under equivalent non-green energy products. This effectively raises the cost of green energy offers relative to other contracts by more than the specified renewable energy charge.<sup>131</sup>

The widespread presence of green energy products in the retail market (often provided at a price premium to energy from other sources) reflects the responses of

<sup>130</sup> Non-accredited products generally source renewable energy from old sources such as large hydro-electric projects.

<sup>131</sup> For example, Click Energy offers customers a 5 per cent prompt payment discount under both its Click Quick and Click Easy offers. While it offers Click Natural, which is 25 per cent GreenPower, at rates equal to the standing offer customers that opt for this product effectively forgo a 5 per cent discount off their energy bill for payment by the due date. For a customer with an average consumption of 6,500 KWh per annum, 5 per cent of the standing offer charge equates to around \$45 to \$50 per annum. Unlike Click Energy’s non-green offers, Click Natural is also offered as a 2-year fixed term contract with associated termination fees, making comparison more difficult.

retailers to the demand for environmentally friendly energy services by a significant proportion of customers. The differentiated offerings by most retailers of green energy services reflects their understanding of the preferences of these customers and is consistent with rivalrous behaviour in an effectively competitive market.

### 5.2.2 Non-price offers

A number of other non-price benefits have been offered by retailers as part of their market offers. Most of these have a specified monetary value but may be valued differently by individual customers.

As part of the Retailer Survey, the Commission asked retailers to provide details of the non-price benefits they were either offering at the time or had previously offered customers since the introduction of retail competition. Nine of the 13 retailers indicated that they had offered at least one non-price benefit in conjunction with their market offers over the last five years. Three retailers had offered four to five different types. The most common non-price benefits offered were magazine subscriptions and vouchers.<sup>132</sup>

Those retailers that had offered one or more non-price benefits in the last five years considered some of them to be relatively important for attracting or retaining customers.<sup>133</sup> Origin Energy noted in its submission to the Issues Paper:<sup>134</sup>

“We have found that a significant sub-set of customers are attracted to non-price offers, an outcome consistent with the generally low percentage of household expenditure on energy. For a typical household, a 10% reduction is still only \$100 per year, and at least some customers will find this less important than other features.”

However, when asked to rate the main reasons why domestic or small business customers would enter into a market contract with their business, most retailers considered non-price benefits to be significantly less important than the offer of immediate price discounts and discounts for prompt payment.<sup>135</sup> This is consistent with the results of the Consumer Survey concerning customer views on the relative importance of price and non-price offers. Only 3 per cent of customers surveyed that had switched to a market contract indicated that the offer of a free gift was one of the

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<sup>132</sup> Other non-price benefits previously offered included sporting packages, movie tickets, shopping discount cards, DVD's, wine giveaways, fuel discounts, rewards points, coffee machines, Qantas frequent flyer points and RAA membership rebates: Retailer Survey.

<sup>133</sup> For ten of the nineteen non-price benefits listed, retailers gave them a rating of 6 or more for their importance in attracting customers: Retailer Survey.

<sup>134</sup> Origin Energy, submission to the Issues Paper, p. 14.

<sup>135</sup> On average, for domestic customers host and new retailers, respectively, gave the offer of lower prices immediately an average rating of 7 to 9, the offer of early payment bonuses an average rating of 5 to 6 and the offer of a free gift an average rating of 5 and 3. A free gift was given an even lower rating of 2 in respect of its importance to small business customers in their decision to take-up a market contract: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, pp. 21-22.

main reasons they switched.<sup>136</sup> This suggests that non-price benefits are generally viewed as a marginal consideration for most customers in their decision to switch.

The Commission's review of the market offers advertised by retailers on their websites suggests that most retailers were either not offering contracts with attached non-price benefits or were not actively advertising such offers. In fact, only one retailer, Victoria Electricity, offered a non-price benefit (a \$2,000 monthly prize draw).<sup>137</sup> This is at odds with the views of organisations such as the Victorian Council of Social Service which suggested that churn in the Victorian market is largely driven by non-price offerings.<sup>138</sup> As with price discounts, the withdrawal of non-price benefits may have been a temporary response by retailers to market conditions at that time.

In the First Draft Report, the Commission invited retailers to comment on whether non-price inducements are currently offered and if so, why the non-price inducements are not actively advertised. Origin Energy noted that its "Go Green For Footy" campaign was advertised extensively via television advertising, radio and print media.<sup>139</sup> However, as noted above, Origin Energy also submitted that general marketing and discounting activity is influenced by wholesale prices and the sensitivity of the regulated price to real market changes.<sup>140</sup> TRUenergy advised that it constantly reviews its suite of products to ensure it meets consumer demands and, in this context, assesses the re-introduction of non-price inducements.<sup>141</sup> TRUenergy also noted that the fact that standing offer tariffs in the years immediately following the introduction of FRC were set below market-based levels significantly contributed to the prevalence of non-price inducements.<sup>142</sup>

The Commission's assessment of price and non-price rivalry suggests there is a strong degree of rivalry between retailers, who are primarily competing for customers through:

- the offer of significant price discounts from the standing offer for the supply of electricity and small to moderate price discounts for the supply of gas; and
- the offer of a range of green energy products that differ in terms of the proportion of green energy used and thus, the price premium over the standing offer tariff.

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<sup>136</sup> Of those customers surveyed that had switched to an electricity market contract, 34 per cent of domestic customers and 58 per cent of small business customers said they had switched because of the offer of lower prices. Only 3 per cent of domestic and small business customers indicated that they had switched due to the offer of a free gift: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 44.

<sup>137</sup> As at 10 December 2007, this promotion was still available.

<sup>138</sup> Victorian Council of Social Service, submission to the Issues Paper, p. 2.

<sup>139</sup> Origin Energy, submission to the First Draft Report, p. 3.

<sup>140</sup> *Id.*, p. 3.

<sup>141</sup> TRUenergy, submission to the First Draft Report, p. 3.

<sup>142</sup> *Id.*

With the exception of a few customers that may not be eligible for offers, the price discounts offered by retailers appear to be available to all customers, with no specific group of customers having been excluded from accessing competitive retail energy rates. In particular, retailers' advertised offers do not appear to distinguish between high and low energy consumers, with the same or similar percentage discounts offered to both.

While some retailers appeared not to have advertised discounted offers or non-price offers, submissions to the First Draft Report indicate that this was, at least in part, attributable to increases in the wholesale cost of energy supply and the ability for retailers to adjust the retail price to reflect these changes.

### 5.3 Marketing practices

In order for customers to take advantage of the price and non-price offers available from retailers, they must be aware of them. In markets involving the sale of relatively low involvement products such as energy, it is reasonable to expect the marketing campaigns of suppliers to be more heavily focused on personal contact. While the vast majority of customers are aware of their ability to choose their energy retailer, few contact retailers directly, although the proportion of customers that have has increased since the 2004 ESC Review. The Consumer Survey reveals that only 10 per cent of domestic customers had contacted an electricity retailer and 6 per cent a gas retailer over the last five years, but this is up from 8 per cent for electricity in 2004. Customer-initiated contact for gas remains steady at 6 per cent. Similarly, 12 per cent of small business customers had approached an electricity retailer and 6 per cent a gas retailer, up from 4 per cent in 2004.

In a market for relatively low involvement products such as energy, search and switching costs may be high. As such, retailers will attempt to overcome customer disinterest by employing direct marketing campaigns which bring the information to the consumer. Such approaches are likely to be more effective in encouraging customers to switch, and their widespread use is likely to be indicative of strong rivalry between retailers. Despite the fact that very few customers have initiated contact with a retailer, a large proportion (over 70 per cent of electricity and 40 per cent of gas customers) have been contacted by a retailer either in person, by phone or by some other means. The proportion of customers that have been contacted by a retailer has increased significantly since 2004 when less than 35 per cent of electricity and 25 per cent of gas customers indicated that they had been contacted.<sup>143</sup>

Some retailers may adopt broad-based marketing campaigns in an effort to appeal to a large range of customers. Others may opt for a more targeted approach in an effort to establish themselves as niche players. While competition is likely to be stronger where suppliers compete for a wide range of customers, smaller niche players also have the potential to constrain the behaviour of larger firms, particularly in those markets characterised by low barriers to expansion or where particular groups of consumers have different requirements. As noted in Chapter 3, where there is

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<sup>143</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 22.

sufficient rivalry between retailers for most types of customers and a sufficient number of marginal customers are switching, competition is likely to be effective in ensuring that retailers' price, quality and service offerings reflect their efficient costs and the preferences of customers.

This section examines the sales and marketing channels used by retailers and the extent to which retailers actively compete for different types of customers.

### **5.3.1 Sales and marketing channels used by energy retailers**

Retailers use a range of sales channels to market their offers to both residential and small business customers. Sales channels may be direct, such as door-to-door sales and telesales, or more indirect, for example, mail outs or bill inserts, internet advertising, affinity retailing, and television, radio, print and outdoor advertising.<sup>144</sup> Table 5.2 below shows the various sales channels used by retailers and the average effectiveness of each channel in attracting customers as rated by retailers.

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<sup>144</sup> Affinity retailing refers to advertising or selling products or services through an affiliated entity (e.g. AFL Victoria or energy appliance outlets). Outdoor advertising refers to advertising in public places such as at bus shelters and on billboards.

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**Table 5.2**      **Number of retailers using each sales channel and the average rating of effectiveness**

Sales or Marketing Channel	Host Retailers			New Retailers		
	No. (of 3) <sup>1</sup>	Average Rating of Effectiveness		No. (of 10) <sup>1</sup>	Average Rating of Effectiveness	
		Domestic	Small Business		Domestic	Small Business
Door knocking	3	■	●	7	■	●
Outbound telesales	3	●	●	8	●	●
Inbound telesales	3	■	●	6	●	●
Internet <sup>2</sup>	3	●	●	10	◆	◆
Direct Mail	3	●	●	4	◆	◆
Affinity Retailing	3	●	◆	3	●	●
Television	2	◆	◆	2	◆	◆
Radio	2	◆	◆	2	◆	◆
Newspaper and Other Print Media	3	◆	◆	1	◆	◆
Outdoor Advertising	1	◆	◆	0	◆	◆

■ = Rated highly effective (between 8 and 10)    ● = Rated moderately effective (between 4 and 7)  
 ◆ = Rated relatively ineffective (between 1 and 3)

Source: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 28.

Notes: (1) Retailers are assumed to use this sales channel only where they indicate that terms and conditions, tariffs and/or details of non-price incentives are provided via this channel. (2) Three new retailers indicated that they do not provide information via the internet, however, all retailers have an internet site.

The most commonly used sales channels for all retailers are the more direct forms, namely door-to-door sales and telemarketing. This is indicative of the active rivalry between retailers in a market where few customers take the initiative to seek out offers in the absence of direct contact initiated by a retailer.<sup>145</sup> Host retailers AGL, Origin Energy and TRUenergy also use other indirect “above-the-line” marketing channels such as television, radio and print advertising, although the amount of information provided to customers via these channels tends to be limited. At least

<sup>145</sup> Of all domestic customers that responded to the Consumer Survey, only 10 per cent indicated that they had contacted an electricity retailer and 6 per cent a gas retailer over the last five years. Similarly, only 12 per cent of small business customers had approached an electricity retailer and 6 per cent a gas retailer in that time: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 22.

two new retailers actively advertise their brand, with most others considering such advertising to be unnecessary in light of the effectiveness of direct sales techniques.

The use of direct forms of marketing in preference to television, print and radio advertising is consistent with international experience in energy markets and is reflective of customer characteristics and attitudes to energy supply as discussed in Chapters 4 and 6.<sup>146</sup>

All retailers consider door-to-door sales and telesales to be the most effective forms of marketing given the homogeneous nature of energy and the generally low levels of customer interest in investigating their supply options. As noted by Origin Energy in its submission to the Issues Paper:<sup>147</sup>

“...the nature and types of marketing present in the retail energy market are more reflective of the type of product being sold rather than of competition per se. The marketing of energy is typical of marketing for a commoditised, low involvement, ‘hygiene’ product, where high cost television advertising has limited benefit other than brand awareness. Thus, the degree of competitive activity can not be readily observed or fully accounted for by simply reviewing general advertising such as on television and radio. Preferred channels used by all competitors appear to be door to door, telemarketing and internet.”

This view was supported by a new retailer who noted:<sup>148</sup>

“...unless you bother someone, then you’re kidding yourself. They’re just not going to come looking for you.”

Two submissions to the Issues Paper suggested that the prevalence of door-to-door sales and telemarketing was indicative of an immature, non-competitive market. These submissions also noted that direct marketing techniques have been proscribed in the financial services and credit industries due to the significant financial implications that may result from consumers making uninformed decisions.<sup>149</sup> The Consumer Action Law Centre observed:<sup>150</sup>

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<sup>146</sup> See Ofgem, *Marketing Gas and Electricity: Consultation Document*, January 2000. The relatively low use of television, radio and print advertising, particularly by new retailers is also consistent with retailers’ views of the importance of brand recognition. Only two of the ten retailers that responded to the Retailer Survey rated brand recognition as one of the main reasons why customers entered into a market contract with their business. None of the retailers surveyed considered brand awareness to be a strong barrier to entry or expansion of new retailers.

<sup>147</sup> Origin Energy, submission to the Issues Paper, p. 10.

<sup>148</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 25.

<sup>149</sup> Consumer Action Law Centre, submission to the Issues Paper, p. 8; Victorian Council of Social Service, submission to the Issues Paper, p. 3.

<sup>150</sup> Consumer Action Law Centre, submission to the Issues Paper, p. 8. The Commission notes that in its submission Consumer Action did not seek an outright ban on door-to-door sales in the energy

“...these sales channels are in and of themselves problematic, not only for individual consumers but also for the competitive market. By their very nature, door-to-door and telephone sales involve high pressure sales techniques. We note that in the financial services industry, there is an outright ban on door-to-door sales of financial products and services and there is also a ban on door-to-door selling of consumer credit. This is a proscriptive regulation, which recognises that, faced with a salesperson on their doorstep, people infrequently make rational, welfare maximising decisions, especially those most vulnerable customers with limited contractual experience.”

The Commission notes these comments and similar submissions from other stakeholders, and recognises the potential for consumers to be misled or pressured by unsolicited door-to-door sales representatives or telemarketers.<sup>151</sup> However, it does not consider the emphasis on direct marketing amongst retailers is indicative of either an immature or non-competitive market. Rather, the use of such techniques reflects the recognition by retailers that many customers regard energy services as a homogenous, low involvement commodity for which they are not inclined to undertake market search activity to find superior price/service offers. In these circumstances, direct sales techniques are a cost-effective means for retailers to reduce customer search costs and motivate customer interest. Provided adequate protections are in place to safeguard consumer interests, direct selling is a legitimate form of marketing for energy services.<sup>152</sup>

Given the homogenous, low involvement nature of energy supply, many customers do not consider the time, effort and cost of searching for alternative supply options to be worth the potential gains that could be made from switching supplier. Where such demand conditions lead to low customer involvement, retailers have a strong incentive to market their service offerings directly to customers. In doing so, they assist in reducing search and transaction costs to customers who may otherwise not actively investigate whether more beneficial options are available to them. In the Commission’s view, the use of direct sales indicates that retailers are seeking to actively inform customers of the benefits available from switching in an attempt to overcome low customer interest in energy services.

In the absence of any evidence of systemic problems with the marketing activities of retailers<sup>153</sup>, the Commission does not consider that prohibition of direct sales techniques in the energy market is warranted. Rather, the Commission is of the view that the prevalence of direct sales techniques by both host and new retailers is indicative of a strong degree of retailer rivalry, consistent with effective competition.

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market. Rather, it suggested that the Commission be made aware of the reasons for the proscriptions in other industries.

<sup>151</sup> The specific issues facing the demand-side and the submissions to the First Draft Report addressing these matters are discussed in greater detail in section 5.5 and Chapter 6.

<sup>152</sup> There are a number of companies that provide direct selling services to a wide range of Australian businesses. Long-standing organisations such as the Direct Selling Association of Australia (DSAA) have developed with the aim of promoting ethical methods of direct selling among their members. The DSAA was formed in 1967. See [www.dsaa.asn.au](http://www.dsaa.asn.au) for more detail.

<sup>153</sup> The Commission’s analysis of whether systemic problems exist is set out section 5.5.

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### 5.3.2 Business models, target customers and differentiation of marketing strategies

The extent to which retailers actively compete for different types of customers is reflected in both the types of products or services that they offer as well as the extent to which they target their marketing activities to particular customer groups. In general, competition is likely to be more effective in those markets where a number of retailers target a wide range of customer groups.

As outlined in Chapter 4, Victorian energy retailers appear to operate under a range of different business models. The three host retailers – AGL, Origin Energy and TRUenergy – appeal to the mass market through the offer of electricity only, gas only (TRUenergy only) and dual fuel products with a range of different features.<sup>154</sup> Some new retailers also appeal to the mass market whereas others actively target either residential or small business customers.

With the exception of a few new retailers, most retailers do not appear to target specific customer groups.<sup>155</sup> Rather, each retailer develops a range of products with different features in order to attract customers that value different attributes. As noted in section 5.1 above, most retailers have generic contracts which feature price discounts from the standing offer, discounts for prompt payment, non-price incentives and/or green energy.<sup>156</sup> These offers are generally made available to all customers who are free to self-select products that contain features of most value to them. Submissions to the First Draft Report note that marketing strategies aimed at the broader customer base are likely to continue, provided that retailers are able to set cost-reflective competitive prices.<sup>157</sup>

While most of the products developed by retailers are generic in nature, a number of retailers focus their door-to-door sales and telesales campaigns on localities that reflect their “preferred customer” profile.<sup>158</sup> For example, both host and new retailers appear to target their direct marketing efforts to areas where there is sufficient density to make door-knocking cost-effective. There is also evidence that retailers consider the extent to which customers within a region are likely to have the capacity to pay their energy bills. New retailers are also likely to target their marketing efforts to areas where there is likely to be a larger proportion of customers

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<sup>154</sup> AGL and Origin Energy also have retail outlets that offer a range of energy-related products and services, with a primary focus on energy efficiency.

<sup>155</sup> Those retailers that focus on customers with specific characteristics include Powerdirect, Jackgreen and Click Energy. Powerdirect primarily focuses on the acquisition of small business customers. Jackgreen focuses on the acquisition of high value domestic customers that are willing to pay for green energy supply, whereas Click Energy focuses on the acquisition of customers through its internet service.

<sup>156</sup> See Appendix C for the details of current offers available to domestic and small business customers.

<sup>157</sup> Energy Suppliers Association of Australia, submission to the First Draft Report, p. 4; Simply Energy, submission to the First Draft Report, p. 2.

<sup>158</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 30.

with higher energy consumption.<sup>159</sup> These customers tend to be preferred given that customer acquisition costs are fixed and can be substantial.<sup>160</sup> As noted above, the structure of the standing offer tariff may also leave less room for profitable discounting for low volume customers.

While retailers would be expected to initially target those suburbs which are likely to prove most profitable, as long as positive margins are available across the state, there is no reason to expect that marketing campaigns would not be extended to all customers. This view is supported by the esaa, who noted:<sup>161</sup>

“... mass market energy retailing is evolving into a high volume, low margin business model where retention of the maximum number of customers possible is one of the most effective ways for a retailer to maximise its return ...

There is little incentive for retailers to limit market offers to customers characterised by some as relatively less attractive as long as the offers are reflective of the underlying costs to serve.”

There is also little evidence to suggest that the marketing efforts of retailers have solely focused on specific locations or on customers with high income or energy consumption levels. The results of the Consumer Survey suggest customers in rural areas are only slightly less likely to have been contacted by an electricity retailer than customers in Melbourne and regional centres and no less likely to have been contacted by a gas retailer.<sup>162</sup> For both electricity and gas the incidence of contact did not differ greatly depending on whether the customer was a high or low energy user or had a relatively high or low household income.<sup>163</sup> The results also suggested

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<sup>159</sup> Both host and new retailers consider customer location to be one of the most important customer characteristics when making offers. On average, new retailers considered energy consumption to be the most important customer characteristic whereas host retailers considered this to be of only moderate importance: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p.19.

<sup>160</sup> Retailers suggest that the average acquisition cost for a domestic customer is between \$136 to \$137 and for a small business customer ranges between \$217 to \$250: *Ibid*, p. 32. Retailers will make higher absolute returns from customers with high energy consumption over the course of their supply agreement where the variable component of the tariff structure (i.e. the charge per kWh or per GJ) exceeds the variable cost of supply. These returns can be used to recover the fixed costs of acquisition and supply. Retailers may be much more limited in their ability to recover their fixed costs from low use customers, particularly if the structure of the standing offer tariff is not reflective of the cost of supplying these customers.

<sup>161</sup> Energy Supply Association of Australia, submission to the First Draft Report, p. 5.

<sup>162</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, pp. 21-24.

<sup>163</sup> Gas customers with a household income over \$75,000 per annum were slightly more likely to have been contacted by a gas retailer. Note that high energy consumers were considered to be those that consumed over 5 MWh per annum of electricity and over 60 GJ per annum of gas. Approximately 34 per cent of all electricity customers and 25 per cent of all gas customers indicated that they were high energy consumers according to this categorisation: *Ibid*, p. 24.

that retailers do not focus their marketing efforts on more centrally located businesses or businesses with high energy consumption.<sup>164</sup>

When marketing in a particular location, retailers are unlikely to avoid, and may not even be able to identify, particular customers according to their energy consumption. As one new retailer noted, while door knocking campaigns tend to be targeted at suburbs that are likely to have higher than average energy consumption, it would not avoid houses within a target suburb that did not appear to meet a particular consumption threshold:<sup>165</sup>

“Potentially, you know, you would look for things like ‘Oh there’s an air conditioner in the house, there’s this sort of stuff, oh yeah they’ve got a pool’. And that’s just a natural thing for retailers to look at. That’s not to say that if the next door neighbour didn’t have all that sort of stuff we wouldn’t knock on the door and try and sell them a contract - of course we would but again it is an important factor of where you go and what you do.”

This suggests that retailers are either not capable of accurately identifying high energy use or high income customers<sup>166</sup> or, alternatively, that they adopt broad marketing strategies in order to capture a diverse range of customers to maximise customer take-up.<sup>167</sup> Indeed, one retailer noted that it found little benefit in pro-actively attempting to target certain demographic groups or consumption levels. The Energy and Water Ombudsman (Victoria) (EWOV) noted in its submission to the Issues Paper that in its experience marketing is not being directed to customers in specific socio-economic groups.<sup>168</sup> The Consumer Utilities Advocacy Centre also noted that there is little evidence of cherry-picking by new entrants in Victoria.<sup>169</sup>

The Consumer Survey results suggest that the majority of customers that have contacted or have been contacted by a retailer have been made an offer (at least 68 per cent of domestic customers and 76 per cent of small business customers). Very few (1 per cent of domestic customers and 3 per cent of small business customers) appear to have been refused an offer. In a number of instances, the reason given by customers as to why they were refused an offer could not be attributed to the actions of the retailer. For example, in some cases the retailer was already providing energy to the customer and in others the customer was either not

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<sup>164</sup> Small business customers in rural areas were just as likely to have been contacted by an electricity retailer as customers in Melbourne and regional centres. Small businesses with relatively low average energy consumption were also just as likely to be contacted by a retailer as high energy users. High energy consumers were considered to be those that consumed between 40 and 160 MWh per annum of electricity and over 150 GJ per annum of gas. Approximately 23 per cent of all electricity customers and 38 per cent of all gas customers indicated that they were high energy consumers according to this categorisation: *Ibid*, pp. 23-24.

<sup>165</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, pp. 30-31.

<sup>166</sup> This view is supported by Simply Energy, who noted that it not possible to accurately identify high consumption customers by locality: submission to the First Draft Report, p. 2.

<sup>167</sup> Energy Supply Association of Australia, submission to the First Draft Report, p. 4.

<sup>168</sup> Energy and Water Ombudsman (Victoria), submission to the Issues Paper, p. 8.

<sup>169</sup> Consumer Utilities Advocacy Centre, submission to the Issues Paper, p. 8.

interested in what the retailer had to say or was left with information which they could follow up on their own initiative.

One specific customer group identified by the Consumer Survey as less likely to be contacted by an energy retailer are those that live in rented accommodation.<sup>170</sup> These customers may be more difficult for retailers to contact via direct sales methods (e.g. they may be more likely to live in a secured apartment as opposed to a house and less likely to have a landline).<sup>171</sup> They may also be considered more likely to be low consumption customers and therefore not be attractive to new retailers. However, as noted above, renters are one of the groups of consumers more likely to have switched to a market contract, which suggests that, to the extent retailers are not contacting these customers directly, this group may not be receiving the maximum benefit from the competitive market.

Another type of customer who may be less likely to be contacted by retailers are customers with a high credit risk. Some retailers advised that they have access to telemarketing mapping packages that show average credit risk by suburb and can therefore identify suburbs that are less attractive for the purpose of door-to-door sales and telesales campaigns.<sup>172</sup> At least two retailers limit their market offers to those customers that meet their credit worthiness conditions. While host retailers currently have an obligation to supply customers that have limited capacity to pay for their energy supply, the effectiveness and appropriateness of the current arrangements to assist customers in financial hardship may require review if retail price regulation were removed. This is a policy matter which is discussed in more detail in Chapter 9.

Although there may be some customers that are ineligible for certain offers due to their personal circumstances, there is little evidence to suggest that those customers that are more likely to be considered high credit risk have been excluded from the marketing activities of retailers.<sup>173</sup> Further, Simply Energy submitted that suburbs

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<sup>170</sup> Of those domestic customers living in rented accommodation, only 63 per cent had been contacted by an electricity retailer compared to 76 per cent of home owners. Similarly, only 39 per cent of those with a gas connection had been contacted by a gas retailer compared to 47 per cent of home owners: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, Table B, pp. 21-22.

<sup>171</sup> In interviews conducted as part of the Retailer Survey, a number of retailers noted that they avoid apartment blocks and townhouses unless there was easy access. This does not reflect active discrimination on the part of retailers, but rather, the fact that security access systems pose a physical barrier to contact with customers in these types of premises: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 31.

<sup>172</sup> *Id.* At least two retailers noted in interviews that they used or had access to these packages, although it was unclear whether they chose not to market in areas identified as having a high proportion of credit risk customers: Retailer Survey.

<sup>173</sup> Results of both the Customer Survey and the survey recently conducted by the Footscray Community Legal Centre (FCLC) suggest that customers in lower socio-economic groups, who are likely to have a lower capacity to pay their energy bill, have not been precluded from the marketing activities of retailers. Results of the Consumer Survey suggest that customers with a household income of less than \$25,000 per annum were no less likely than other customers to have been contacted by an electricity retailer: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, Table B, pp. 21-22. Results of the FCLC survey indicate that a minimum of four different energy retailers had door-

that are identified as low credit risk are unlikely to be avoided by retailers given the combined effect of high levels of competition and the Do Not Call register on the ability of retailers to sign up new customers.<sup>174</sup>

Overall, the evidence before the Commission of the marketing strategies adopted by retailers suggests there is active rivalry between them for the majority of customers. While some new retailers specifically target only residential or small business customers, or customers that appear to have higher than average energy consumption, the remainder adopt a broader approach in an effort to attract a range of different customers over all geographic regions in Victoria.

The direct selling techniques by which most retailers market their offers to customers is also indicative of a strong degree of retailer rivalry. Given the nature of demand for energy, retailers have a strong incentive to market their offers to customers in order to encourage them to switch. That all retailers adopt these sales strategies, including host retailers that already have an established customer base, suggests that all retailers need to actively market their offers in order to maintain and grow their customer share.

## **5.4 Provision of information**

In competitive markets, suppliers have an incentive to provide customers with relevant information about their products and services and the advantages they offer relative to that of their competitors. However, in markets that are in transition from monopoly to competitive supply or involve the sale of products with relatively complex pricing structures, information provided by suppliers independently of one another may not allow for easy comparison. In some such markets, policy or regulation may mandate certain forms of information disclosure to assist customers in making informed choices regarding their supply options.

### **5.4.1 Mandatory information disclosure**

In Victoria, legislation, codes and guidelines prescribe the type and form of certain information that energy retailers must provide to customers about their market offers. These requirements were in part developed in recognition of the apparent complexity of energy retail pricing. Energy retail prices may consist of a combination of fixed and variable charges, different variable charges based on energy consumption and different charges for energy use in peak and off-peak periods. In order to determine which market contract offers the best value, customers require access to information that allows them to compare offers across retailers and information in regard to their own energy consumption.

Energy retailers are required to disclose information about their market offers in accordance with the ESC's *Guideline No. 19: Energy Product Disclosure* (Product Disclosure Guideline) and *Code of Conduct for Marketing Retail Energy in Victoria*

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knocked residents in housing estates in the inner west region suburbs of Ascot Vale and Braybrook in the 12 months to June 2007: FCLC, submission to the Issues Paper, p. 6.

<sup>174</sup> Simply Energy, submission to the First Draft Report, p. 2.

(Marketing Code).<sup>175</sup> The specific information required to be provided by retailers pursuant to these instruments includes:

- for each market offer, a Product Information Statement (PIS) setting out all applicable tariffs and other relevant fees and charges;<sup>176</sup> and
- an offer summary for the customer's chosen contract, which contains the same information as that included in the relevant PIS, excluding eligibility criteria and certain disclaimers.<sup>177</sup>

Each retailer is required to publish the PIS for each market contract on its website and establish an online process by which customers can easily identify the PIS (and therefore the market contract) that is most relevant for their circumstances. Each PIS must contain a statement which directs the reader to the ESC's website and Energy Comparator for further information.

A retailer must also provide customers with an offer summary on request or when providing a customer with information about the terms of a new market contract. Offer summaries must be a separate document to the full terms and conditions of the contract. In the case of retailers signing customers at their doorstep, the offer summary must be provided, and the customer given reasonable opportunity to consider it, before they enter into the contract.

Retailers are also required to provide customers with a range of other information in accordance with the Marketing Code prior to entering into a contract. Further information about the disclosure obligations contained in the Code are set out in Appendix D.

#### **5.4.2 Retailer compliance with information requirements**

The ESC monitors compliance with the specific codes and guidelines that apply to retailers. In its compliance report spanning 2005-06, the ESC noted that whilst the introduction of its Product Disclosure Guideline initially caused some difficulty for most retailers, the degree of compliance is now high.<sup>178</sup> In 2005-06, instances of non-compliance related to:

- clarity of the explanation of how retailers vary terms, conditions and prices;
- the need for customers to provide technical information before being provided with a PIS;
- lack of reference to the Energy Comparator or link to the Product Disclosure Guideline;

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<sup>175</sup> Essential Services Commission, *Guideline No. 19: Energy Product Disclosure*, December 2005 and Essential Services Commission, *Code of Conduct for Marketing Retail Energy in Victoria*, October 2004.

<sup>176</sup> Product Disclosure Guideline, clause 2.

<sup>177</sup> Product Disclosure Guideline, clause 3.

<sup>178</sup> Essential Services Commission, *2005-06 Compliance Report for Victorian Energy Retail Businesses*, February 2007, p. 11.

- lack of information regarding notification of termination;
- incorrect basis of fees and charges.

In all cases investigated, the retailer either made the necessary amendments to comply with the Product Disclosure Guideline or was working with the ESC to resolve the issue.

The ESC recently released its compliance report for 2006-07.<sup>179</sup> While the Commission has been unable to incorporate the ESC's report fully into its analysis, it notes that the subject matter of instances of non-compliance in 2006-07 are broadly similar to those observed in 2005-06.

Some submissions suggested that in some instances retailers were not complying with their information requirements. In particular, the Footscray Community Legal Centre (FCLC), who conducted its own survey of residents of public housing estates within the inner west region of Melbourne, noted that 45 of the 65 survey respondents indicated that residents were not invited to read documentation before signing offers nor did the sales representative leave documentation about the offer for the consumer to read.<sup>180</sup> EWOV, in response to the First Draft Report, observed:<sup>181</sup>

"Problems with information provision are common in the marketing cases EWOV receives ... In other cases, customers are told they can only have detailed information if they do switch, and then if they don't like what they read they can opt out during the cooling-off period."

The Consumer Utilities Advocacy Centre submitted that the regulatory obligations fail if customers are unaware of their rights to request and receive information.<sup>182</sup>

"The Commission's analysis overlooks the fact that the Victorian regulations mandating product information disclosure rely heavily on the customer taking the initiative to find that information – Product Information Statements are available online, but there is no requirement for a retailer to offer that information to a consumer or to tell a customer that it exists."

The Commission acknowledges that there are instances where information about market offers is not provided in accordance with the relevant code or guideline.<sup>183</sup> The ESC's compliance reports for the past two years indicate a high degree of

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<sup>179</sup> Essential Services Commission, *2006-07 Compliance Report for Victorian Energy Retail Businesses*, November 2007.

<sup>180</sup> Footscray Community Legal Centre, submission to the Issues Paper, p. 6.

<sup>181</sup> Energy and Water Ombudsman (Victoria), submission to the First Draft Report, p. 3.

<sup>182</sup> Consumer Utilities Action Centre, submission to the First Draft Report, p. 4.

<sup>183</sup> For examples of non-compliance conduct, see Essential Services Commission, *2005-06 Compliance Report for Victorian Energy Retail Businesses*, February 2007, pp. 12-16 and Essential Services Commission, *2006-07 Compliance Report for Victorian Energy Retail Businesses*, November 2007, pp. 12-22.

compliance across the market as a whole and indicates that remedial action is taken where non-compliance is identified. The Commission considers that retailers have an obligation to facilitate the provision of information specified in codes and guidelines and should be pro-active in disseminating information to customers. It also notes that monitoring and enforcement of licence obligations in relation to information disclosure is being undertaken by the ESC and that instances of non-compliance should be notified to the ESC for appropriate action.

The Commission notes the results of the survey by the FCLC, however, it has not been persuaded that the survey findings are reflective of market-wide non-compliance. As noted by EWOV, it is not possible to be sure whether a customer was not told about a specific term or condition or did not take it in given the amount of information that is required to be conveyed before entering into a contract.<sup>184</sup> Nonetheless, the issues described by the FCLC are of concern and should be taken up with the ESC.

### **5.4.3 Other information sources**

In addition to evaluating the information provided by retailers, customers can compare market offers with their current arrangements (either the standing offer or a market contract) through the ESC's online Energy Comparator. This tool estimates the annual charge that would be payable under a market offer on the basis of the customers' consumption profile and compares this with the amount the customer currently pays under their existing arrangement.

While the Energy Comparator allows customers to compare contracts and assess how different market offers are likely to affect their annual bill, it is time consuming and requires the customer to have or have searched for information regarding the terms of one or more market contracts. The ESC notes that the comparison process takes around 20-30 minutes and that in order to use the tool, customers are required to have a recent energy bill and information about a new offer, e.g. a PIS, offer summary, or contract schedule. The Consumer Utilities Advocacy Centre submitted that customers who made switching decisions based on the information provided by door-to-door salespeople were not sufficiently informed because the information provided at the doorstep covered only a single product.<sup>185</sup> A suitably comprehensive and simple to use comparator would enable a customer to undertake additional search activities before deciding whether to switch retailers.

The value of the Energy Comparator to customers who wish to shop around for a better deal could be enhanced by introducing a functionality that allows customers to identify all of the various offers available or the lowest price offer available in their particular location, and takes into account the value of any non-price incentives.

The Commission understands that other independent energy comparator services are currently being developed. It is anticipated that these services will allow

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<sup>184</sup> Energy and Water Ombudsman (Victoria), submission to the Issues Paper, p. 10-11.

<sup>185</sup> Consumer Utilities Advocacy Centre, submission to the First Draft Report, p. 4. See also Consumer Action Law Centre, submission to the First Draft Report, p. 8.



consumers to identify the range of products that retailers have on offer and make relatively simple comparisons to determine which contract best meets their needs.

The Commission notes that such services would be a welcome development, particularly in an environment where over 50 per cent of customers have already switched to a market contract. A service which allows for comparison between market contracts as well as between a market offer and the standing offer will be of increasing relevance for customers that are either approaching the end of their current contract term or are contemplating switching during the period of their contract.

Comparison services such as those currently under development have been a long-standing feature of the energy market in the United Kingdom. There are currently twelve internet-based energy price comparator services that are accredited by energywatch, some of which have been operating for over five years.<sup>186</sup> A similar comparator tool and information website, “Power to Choose”, is operated by the Public Utilities Commission of Texas for the benefit of energy customers in that state.<sup>187</sup> Equally, it is critical that the Marketing Code and related regulations are effectively enforced to provide retailers with strong incentives to comply with existing information disclosure requirements.

The current information disclosure requirements in relation to energy retail contracts in Victoria are comprehensive. Given the high level of compliance with these requirements reported by the ESC and the availability of the ESC’s online comparator service, the Commission considers there to be sufficient information available to customers to enable them to make an informed choice in relation to their energy supply. However, in an environment of high compliance, the Commission considers that it is incumbent upon retailers to ensure that employees and agents undertaking direct marketing activities on behalf of the retailer are providing information to customers in accordance with these licence obligations. In order to provide adequate incentives for such compliance, the ESC should continue to investigate and take any necessary action where breaches or potential breaches of information disclosure requirements are reported.

The development of other commercial online comparator services has the potential to enhance customer’s ability to compare offers although the Commission notes that such services will likely require some degree of retailer oversight.

## 5.5 Prevalence of mis-selling practices

While high levels of direct marketing generally reflects a strong degree of retailer rivalry, such practices do have the potential to undermine competition to the extent

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<sup>186</sup> energywatch has developed a voluntary code of practice for companies providing domestic and gas price comparison services over the internet in 2002. Companies that meet the accreditation criteria set out in the latest code (the Confidence Code) may feature the energywatch logo on their website. For more information see: [www.energywatch.org.uk/help\\_and\\_advice/saving\\_money/price\\_comparison\\_services/index.asp](http://www.energywatch.org.uk/help_and_advice/saving_money/price_comparison_services/index.asp)

<sup>187</sup> For more information see [www.powertochoose.org](http://www.powertochoose.org).

that they involve misleading information or coercive selling methods. Customers that switch to market contracts in response to the use of high pressure sales tactics, the provision of misleading information or other forms of deceptive conduct may be worse off under their new supply arrangement. However, if the regulatory compliance framework is effective in preventing systemic breaches of regulatory instruments, such practices are unlikely to affect the development of effective competition. This section considers the extent to which retailers have been found to have engaged in undesirable marketing practices by reference to complaint data and the level of customer satisfaction with the switching process.

### 5.5.1 Marketing Code of Conduct

Victorian energy retailers are bound by the Marketing Code, which is a code of conduct governing energy retailers' marketing activities.<sup>188</sup> The Code reflects the key provisions in the *Fair Trading Act 1999* (Vic) (FTA) and the *Trade Practices Act 1974* (Cth) (TPA), specifically in relation to misleading or deceptive behaviour and unconscionable conduct.<sup>189</sup> Further information about the specific obligations contained in the Marketing Code are contained in Appendix D.

A number of submissions to the Issues Paper and the First Draft Report expressed the view that marketing misconduct was both systemic and widespread among energy retailers in Victoria.<sup>190</sup> The main concerns were:

- transference of customers to market contracts without their explicit informed consent;
- failure to provide information to customers, including refusal to provide information unless the customer agrees to transfer;
- the marketing of non-price inducements, the receipt of which are reliant on conditions that are not made clear and are difficult for customers to meet, particularly for low-income customers;
- the marketing of "renewable" or "green" energy contracts that are not accredited GreenPower; and
- the provision of misleading information or the omission of relevant information by door-to-door salespeople, including:
  - misrepresenting the savings that could be made under the contract on offer;

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<sup>188</sup> Essential Services Commission, *Code of Conduct for Marketing Retail Energy in Victoria*, October 2004.

<sup>189</sup> The Marketing Code does not limit any rights a consumer may have under the TPA or the FTA.

<sup>190</sup> In response to the Issues Paper see, for example, submissions from Consumer Action Law Centre (pp. 5-8); Consumer Utilities Advocacy Centre (pp. 4-5); Energy and Water Ombudsman (Victoria) (pp. 5-7); Footscray Community Legal Centre (p. 8); Tenants Union of Victoria (p. 18) and Victorian Council of Social Services (p. 3). In response to the First Draft Report see, for example, submissions from Alternative Technology Association (p. 2); Consumer Action Law Centre (p. 7) and Consumer Utilities Advocacy Centre (p. 3).

- not informing customers of potential termination fees that may be payable on their existing contract; and
- not informing customers of the risk of high penalty fees on direct debit payment processes.

In assessing whether energy retailing is characterised by systemic mis-selling practices, the Commission has considered whether the evidence demonstrates an issue, problem or a change in provider policy or practice that affects, or has the potential to affect, a large number of customers.<sup>191</sup> As EWOV notes, systemic issues could arise as a result of:

- a system change;
- an alteration in performance levels;
- a policy or procedure change or the lack of policy/procedure;
- lack of clear regulatory guidelines or regulatory non-compliance;
- the conduct of a provider's employee, agent, servant, officer or contractor; or
- the action of a stakeholder (such as a legislative/regulatory change leading to misunderstanding/misapplication of the change).

One of the sources of information the Commission considered in assessing the prevalence of mis-selling practices is the complaints data published by EWOV. EWOV is responsible for dealing with customer complaints about the activities of energy and water suppliers. EWOV collects data on the number and type of complaints made in relation to electricity, gas and dual fuel supplies and publishes these every six months. It also compiles reports on marketing cases which raise potential compliance issues in relation to the Marketing Code and other relevant legislation. These reports are provided to the ESC, the Australian Energy Regulator (AER), Consumer Affairs Victoria (CAV) and the Australian Competition and Consumer Commission (ACCC).

Figure 5.1 below shows the number of cases<sup>192</sup> received by EWOV from 2003 to 2006 in relation to energy billing, market conduct (eg sales or advertising practices) and

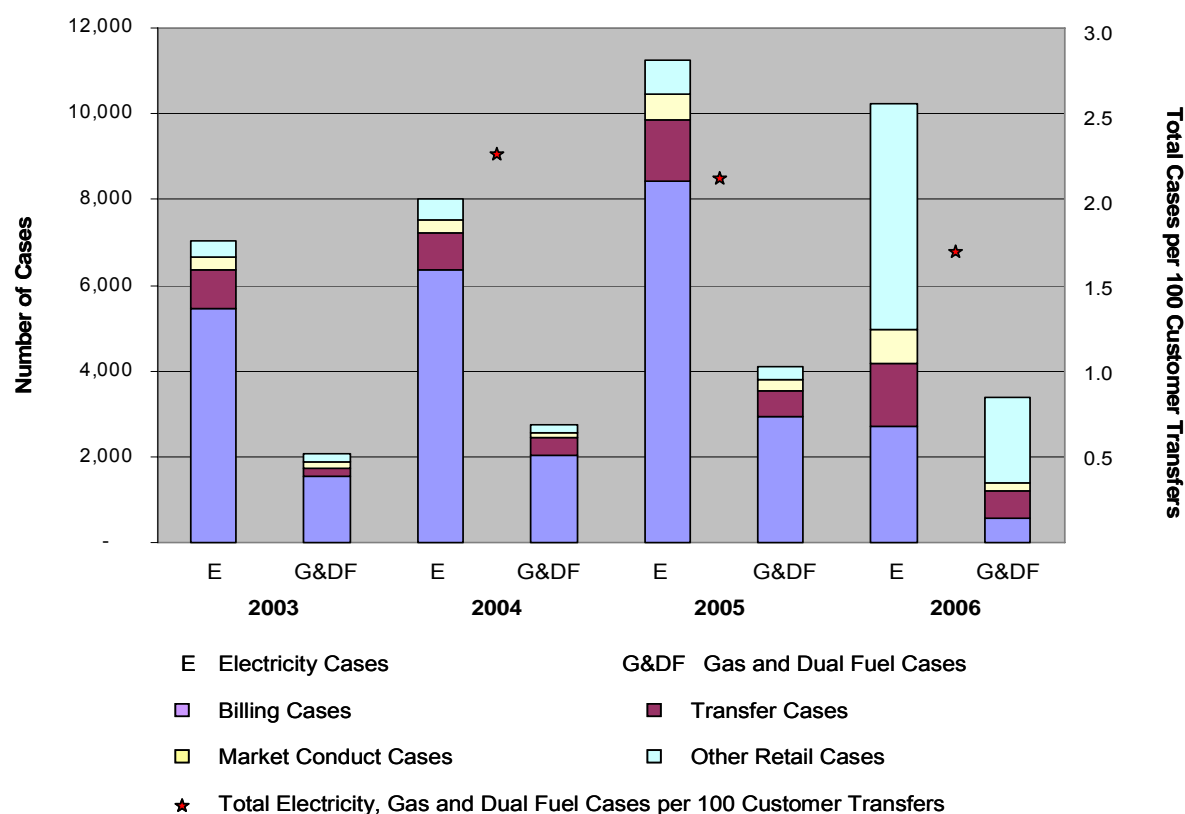
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<sup>191</sup> This definition is based on, but is not identical to, the definition used by EWOV to identify systemic issues: see further Energy and Water Ombudsman (Victoria), *2007 Annual Report*, p. 27.

<sup>192</sup> The term "case" encapsulates all enquires and complaints directed to EWOV by customers. According to EWOV nomenclature, an "enquiry" is a request from a customer for information or a matter that is referred to another agency. A "complaint" is an expression of dissatisfaction regarding a policy, practice or customer service performance of an energy or water provider that is a participant in the EWOV scheme, where a response or resolution is explicitly or implicitly expected: see Energy and Water Ombudsman (Victoria), *2007 Annual Report*, p. 16. In 2006-2007, of the 8,652 electricity complaints received, 39 per cent were received for full investigation, 39 per cent were referred to higher level contact, 19 per cent were referred to the provider and 3 per cent were referred elsewhere.

transfers and other cases about energy retailing as a proportion of customer transfers.<sup>193</sup>

**Figure 5.1 Marketing and other energy retail cases received by EWOV 2003-2006**



\* Maximum number of potential market conduct cases based on EWOV data where actual number of cases not shown

Sources: EWOV Annual Reports, 2003 to 2006, EWOV Resolution, Issue 15 to 22 EWOV Submission to AEMC Issues Paper, NEMMCO and VENCORP

EWOV received 956 cases in relation to the marketing conduct of retailers in the year to 30 June 2006, up from 449 in 2003.<sup>194</sup> These cases represented only 5 to 7 per cent

<sup>193</sup> Customer transfers are used as a proxy for the level of marketing activity. It is expected that the number of customers transferring retailer will increase as more retailers enter the market and a larger proportion of consumers are contacted via door-to-door sales representatives, telemarketers or by direct mail.

<sup>194</sup> Note that not all cases are indicative of a problem with the marketing practices of the retailer concerned. The Commission notes that EWOV recently released its 2006-2007 annual report, but at the time of writing is not in a position to fully analyse the new data and incorporate it into its final analysis. The AEMC has observed that EWOV received 1,493 cases in relation to the marketing conduct of retailers in the year to 30 June 2007, which accounts for some 9 per cent of all cases received by EWOV.

of all cases received by EWOV. Most enquiries and complaints dealt with by EWOV in this period related to billing issues.<sup>195</sup>

While the number of market conduct cases received by EWOV has increased substantially since 2003, this has occurred over a period of new entry and more intense marketing by retailers. Using the total number of gross customer transfers as a proxy for the intensity of marketing activity, Figure 5.1 shows that the total number of cases per 100 customer transfers has fallen from around 2.3 in 2003/04 to around 1.7 in 2005/06 (i.e. from around 23 to 17 cases per 1,000 customers that transferred per year).<sup>196</sup> Issues are spread across retailers with no one retailer having more than 300 complaints made in relation to its marketing practices for electricity, gas or dual fuel offers in 2006.<sup>197</sup>

The number of enquiries and complaints made in Victoria in relation to energy retailing is similar to that observed in other industries such as telecommunications. The total number of enquiries and complaints received by EWOV in relation to the retailing of energy per 100 customers was 0.43 for electricity and 0.19 for gas/dual fuel for the year ended 30 June 2006.<sup>198</sup> Over the same year the number of complaints received by the Telecommunications Industry Ombudsman (TIO) from Victorian customers was 0.513 per 100 customers.<sup>199</sup> While the majority of complaints made to the TIO related to complaint handling, billing and credit management, around 15 per cent related to transfer issues, including transfer without informed consent, and the provision of information regarding prices, terms and conditions.

While energy complaint rates in Victoria are comparable with those observed in telecommunications, lower rates are observable in overseas jurisdictions. For example, the average number of direct selling complaints made to energywatch, the gas and electricity watchdog in the United Kingdom, has fallen from around 0.17 per

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<sup>195</sup> For the year ended 30 June 2006, EWOV changed its reporting framework by further segmenting its case categories such that billing complaints were separated by type. It is therefore likely that the drop in the number of billing complaints shown for the year ended 30 June 2006 is due to the omission of several billing complaint categories not published by EWOV that are included in the figure above as "Other Retail Cases". Given this, it should be noted that for the year ended 30 June 2007, billing issues made up 39 per cent of issues raised by customers, down from 43 per cent in the previous year.

<sup>196</sup> In 2005-2006, 82 per cent of electricity retail cases, 85 per cent of gas retail cases and 89 per cent of dual fuel cases were complaints, with the remainder being customer enquiries. In 2006-2007, complaints comprised 84% of electricity retail cases received by EWOV 6-2007, 81 per cent approximately 78 per cent of cases received by EWOV were complaints.

<sup>197</sup> See Appendix E for a breakdown of the issues raised in complaints and enquiries received for each retailer for the year ending 31 December 2006.

<sup>198</sup> Based on 2,353,401 electricity customers and 1,630,859 gas customers as at 30 June 2006: Essential Services Commission, *Energy Retail Businesses Comparative Performance Report for the 2005-06 Financial Year*, November 2006, p. 2.

<sup>199</sup> Telecommunications Industry Ombudsman, *2006 Annual Report*, 2006, p. 58. Note that results of the Ombudsman's public awareness survey revealed that only 15 percent of customers in Victoria displayed an unaided awareness of the Ombudsman. This rate of awareness is around half that of EWOV based on the Commission's latest domestic and small business customer survey.

100 customer transfers for the quarter ended July 2002 to 0.008 per 100 customer transfers for the quarter ended April 2007.<sup>200</sup>

In the year to 30 June 2007, the ESC investigated five retailers in response to allegations of marketing conduct that was inconsistent with the relevant regulatory obligations. The complaints related to failure to obtain explicit informed consent, transfer without consent or misleading or deceptive conduct by sales representatives of the retailer.<sup>201</sup> The ESC has closed its investigations of AGL and Powerdirect, having satisfactorily resolved them, is continuing to monitor the marketing conduct of Simply Energy<sup>202</sup> and is working to finalise its review of VEL's conduct in 2007. Only two retailers, Country Energy and Jackgreen, were found to have breached the Marketing Code beyond isolated incidents in the year to 30 June 2006.<sup>203</sup> Complaints made in relation to both retailers involved claims of misleading or deceptive conduct.<sup>204</sup> Complaints in relation to Jackgreen also involved the personal conduct of sales representatives and transfer without explicit informed consent.<sup>205</sup> These issues were dealt with by the ESC in consultation with CAV. In both cases the ESC was able to resolve the issue and has taken no further action.<sup>206</sup>

In its submission to the First Draft Report, EWOV suggested that the dissatisfaction amongst energy customers in Victoria was likely to be higher than the reported complaints indicated. EWOV referenced a study by the Society of Consumer Affairs Professionals in 2005 that found that only 27% of dissatisfied customers complain.<sup>207</sup>

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<sup>200</sup> The fall in the complaint rate occurred after the introduction of a range of measures to address the mis-selling practices of sales representatives: Office of Fair Trading, *Doorstop Selling: A report on the market study*, United Kingdom, May 2004, p. 56. See further [www.energywatch.org.uk](http://www.energywatch.org.uk) and [www.oft.gov.uk](http://www.oft.gov.uk).

<sup>201</sup> AGL Sales Pty Ltd, EA-IPR, Powerdirect, Victoria Electricity Ltd, TRUenergy. For further information see: Essential Services Commission, *2006-07 Compliance Report for Victorian Energy Retail Businesses*, November 2007.

<sup>202</sup> The ESC's investigation was initiated while Simply Energy operated as EA-IPR, prior to the sale of EnergyAustralia's interest in the EA-IPR partnership to IPR and the name change to Simply Energy.

<sup>203</sup> Essential Services Commission, *2005-06 Compliance Report for Victorian Energy Retail Businesses*, February 2007.

<sup>204</sup> Country Energy investigated each complaint and submitted a report detailing their findings and subsequent actions, which included staff retraining. A letter was sent to all customers with an offer of different options to ensure that no customer was disadvantaged. See Essential Services Commission, *2005-06 Compliance Report for Victorian Energy Retail Businesses*, February 2007, p. 14.

<sup>205</sup> Jackgreen took a number of actions to address these complaints including the retraining of staff, the disciplining or dismissal of staff where appropriate and the establishment of more adequate monitoring procedures. Jackgreen also undertook to enhance its compliance systems and procedures in response to an investigation by the NSW energy regulator: *Ibid*, p. 15.

<sup>206</sup> In the case of Country Energy the Essential Services Commission decided to take no further action given that only a small number of complaints had been received after the company had instituted corrective measures. In the case of Jackgreen, the Essential Services Commission noted that given that Jackgreen had undertaken a number of actions to increase compliance and that no further complaints have been received in Victoria, it would not take any further action: Essential Services Commission, *2005-06 Compliance Report for Victorian Energy Retail Businesses*, February 2007, pp. 14-15.

<sup>207</sup> Energy and Water Ombudsman (Victoria), submission to the First Draft Report, p. 2. Other submissions suggest that the actual level of dissatisfaction amongst energy customers in Victoria

Even if the number of cases recorded by EWOV in 2006 is multiplied by four (to take account of under-reporting), the Commission remains of the view that the number of potential breaches of the Marketing Code would be relatively low. Therefore, the Commission does not consider that, in quantitative terms, prohibited marketing practices are widespread in Victoria. The low complaint threshold for the ESC to commence an investigation<sup>208</sup> provides a suitable framework for investigating and remedying non-compliance.

The Commission has also taken into account consumer attitudes as reported in the results of the Consumer Survey. The survey findings suggest that even though some customers may have been subject to high pressure sales tactics or misleading conduct, the majority of customers that have switched have done so on the basis of price discounts off the standing offer tariff and believe that the contract they have switched to meets their expectations. Customers that indicated they had switched to a market contract were asked to rate on a scale of 1 to 10, where 10 was considered "excellent", the extent to which the agreement they have to buy electricity or gas has met their expectations. Over 70 per cent of customers gave a rating of 7 to 10 and less than 5 per cent gave a rating of 1 to 4. These responses suggest that the majority of customers who have switched to market contracts in response to the direct marketing initiatives of retailers are of the view that the charges they pay under their agreement are consistent with the information provided to them before they entered the contract. Given the weighting of the survey respondents, the Commission considers these results are likely to be representative of the general attitudes of energy customers in Victoria.

The positive message conveyed by the results of the Consumer Survey were challenged by some submissions to the Issues Paper and the First Draft Report, predominantly lodged by consumer groups. Several submissions put forward case studies as qualitative evidence of misleading or deceptive conduct, unconscionable conduct and other mis-selling practices. EWOV also encouraged the Commission to look beyond the number of complaints and consider the subject matter of the complaints.<sup>209</sup>

The transfer of customers without their explicit informed consent and failure (or refusal) to provide information were two complaint classifications that EWOV submitted warranted further consideration.<sup>210</sup> The Commission acknowledges that instances of mis-selling do occur and that such conduct can have considerable consequences for the affected individuals. Retailers need to face a significant deterrent to misleading and other inappropriate marketing activity and, as such, the Commission encourages the ESC and CAV to take these matters into account in determining whether to investigate and take enforcement action against a retailer.

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was likely to be higher than the number of reported complaints indicated: see, for example, Consumer Action Law Centre (p. 7).

<sup>208</sup> The ESC advised that there were only around 12 complaints escalated by EWOV in relation to Country Energy before an investigation took place.

<sup>209</sup> Energy and Water Ombudsman (Victoria), submission to the First Draft Report, p. 2

<sup>210</sup> *Ibid*, pp. 2-3.

Although the case studies and anecdotal evidence provided in submissions indicate that instances of mis-selling do occur, the Commission is not persuaded by the evidence before it that misleading, deceptive or unconscionable conduct is systemic in energy retailing or is sufficiently widespread so as to preclude competition from being effective. Further, the evidence before the Commission suggests that where mis-selling does occur, it is capable of being adequately dealt with under the current consumer protection framework. Indeed, it appears from a number of the case studies contained in the report by the Consumer Action Law Centre and the Financial & Consumer Rights Council that complaints are being resolved satisfactorily using the existing process.

The relatively low level of complaints to EWOV, particularly in relation to the marketing conduct of retailers, and the high level of satisfaction among customers with the switching process, suggest that retailer marketing has been pro-competitive and has assisted in the development of effective competition. However, the Commission accepts that the personal consequences for individuals that are the subject of mis-selling practices can be significant. For this reason, the Commission considers that retailers should have arrangements in place to ensure the conduct of their direct marketing teams do not place the retailer in breach of their licence obligations. Where instances of non-compliance are identified, the Commission considers that the relevant regulatory agencies should continue to investigate allegations promptly and, where necessary, to take appropriate enforcement action.

## **5.6 Commission's findings**

The Commission's assessment of retailer rivalry suggests that competition for customers is robust and is consistent with that expected in an effectively competitive market. The offers made by retailers reflect two quite distinct preferences of customers; namely, price discounts and offers of green energy products, for which a proportion of customers are willing to pay a price premium.

As at 1 October 2007, most retailers offered electricity market contracts at a discount to the standing offer, with discounts of up to 10 per cent available from some retailers when all price benefits are taken into account. Fewer retailers offer both electricity and gas market contracts and while those that do offer the same price discount for the supply of both fuels, the combined discounts available are lower than those for electricity market contracts, generally around 3-6 per cent. As further discussed in Chapter 8, the lower discounts available under gas market offers may reflect lower margins available under the standing offer for gas.

The marketing conduct of retailers and their strong preference for direct forms of marketing such as door-to-door sales and telesales is also consistent with effective competition. Given the low customer involvement in energy supply, retailers cannot rely on advertising alone to attract new customers. Rather, retailers have an incentive to pro-actively market their products to customers in order to reduce search and transaction costs for those customers that may otherwise not take the initiative to investigate their supply options. In an environment where customers perceive the cost of searching for information to be relatively high compared to the benefit they could obtain from switching supplier, direct selling is likely to be the most efficient way for retailers to improve competitive outcomes for customers.



The current information requirements imposed on retailers appear sufficient to ensure that those customers that wish to investigate their supply options and compare offers are able to do so. While the process involved in comparing offers may be time consuming at present, the Commission considers that this may improve in the future with the development of new on-line energy comparator services.

Evidence available to the Commission also suggests that, on the whole, the marketing activities of retailers are pro-competitive. While complaints have been made in relation to the marketing activities of retailers, the Commission is not persuaded that marketing misconduct is widespread or systemic. It also considers that instances of non-compliance are capable of being, and are being, adequately dealt with by those organisations responsible for addressing complaints and/or breaches of the Marketing Code.

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## 6 Customer Participation and Experience

Customer participation is an important pre-requisite for an effectively competitive market. Where customers can be seen to respond to price or quality differences in the products or services on offer by switching to those that better meet their needs, this contributes to competitive pressure and incentives on suppliers to respond or risk losing patronage and market share. Conversely, in markets where customers do not respond to differences in price and non-price products and service offerings, suppliers may have a degree of market power which enables them to maintain prices above the long-term cost of supply (or alternatively provide inferior service quality) for a significant proportion of their customer base without loss of custom.

As noted in Chapter 4, although energy supply is an essential service, electricity and gas are homogeneous products which are viewed by a large proportion of energy customers as low involvement commodities. Accordingly, many energy consumers may have a low level of interest in exercising choice between retailers and their alternative price/service offerings.

The extent to which customers are willing to participate by actively making decisions about their energy supply arrangements will also depend on the presence or magnitude of search and switching costs relative to the benefits available from changing retailer. Switching costs can be defined as the real or perceived costs that a customer would incur in order to switch supplier that would not be incurred by remaining with their current supplier.<sup>211</sup> Switching costs come in a variety of forms, not all of which are quantifiable in a financial sense. Customers may be further discouraged from switching if they consider the time and effort required to search for information to be relatively high when compared with the actual or perceived benefits to be gained from switching.

The extent to which customers are willing to switch to those contracts that best meet their needs will also depend on the ready availability of relevant information, the ability of customers to adequately process that information and the extent to which customers exhibit particular behavioural biases. For example, customers may display what is known as a “status quo bias”, remaining with the default supplier despite the potential to make gains from switching.<sup>212</sup> Customers may also switch to contracts that do not provide them with the maximum benefit available due to search costs and/or limitations in processing information.

The mere presence of search and switching costs or status quo bias does not mean that competition for a good or service will be ineffective. These factors are

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<sup>211</sup> Office of Fair Trading, *Switching Costs, Economic Discussion Paper 5, Part One: Economic models and policy implications*, A report prepared for the Office of Fair Trading and the Department of Trade and Industry by National Economic Research Associates, United Kingdom, April 2003.

<sup>212</sup> See C. Camerer, S. Issacharoff, G. Lowenstein, T. O'Donoghue and M. Rabin, “Regulation for Conservatives: Behavioural Economics and the Case for “Asymmetric Paternalism”, *University of Pennsylvania Law Review*, 2003, Vol 151:121, p.1,224. The authors cite W. Samuelson and R. Zeckhauser, “Status Quo Bias in Decision Making”, *Journal of Risk and Uncertainty*, 1988, Vol 7.

characteristic of many markets, although the degree to which they discourage switching or informed decision making may differ. As noted in Chapter 4, the general features of customer demand for energy (including the homogenous and commodity characteristics of the service and the regulatory obligations to maintain the security and reliability of supply) are consistent with customers not regarding energy services as differentiated services of high value for which consumer investment of time, effort and cost in market search activities will be worthwhile. These demand conditions can provide strong incentives for energy retailers to market the price and non-price advantages of their service offerings directly to customers. By providing information directly to customers, retailers can differentiate their service offerings from those of their rivals, while at the same time economising on the search and transaction costs of customers which may otherwise discourage many of them from exercising choice.

From a competition perspective, search and switching costs and status quo bias are only considered to be problematic where they are not addressed effectively by pro-competitive direct marketing responses by suppliers and they remain sufficient to deter a relatively significant proportion of customers, or particular subsets of customers, from seeking out and taking up alternative supply options that better suit their needs. However, as discussed in Chapter 3, as long as enough consumers are willing to engage with the competitive market and switch retail supply to obtain a better deal, all consumers can expect to benefit from competition. Only where problems associated with search and switching costs or behavioural bias are widespread and/or retailers are able to discriminate between customers would questions arise about the effectiveness of competition as a result of these market conduct or consumer behaviour issues.

This chapter examines customer experience with energy retailing in Victoria in order to determine whether customer participation in the market is active and consistent with effective competition, and whether there is evidence that search and switching costs, information constraints or other behavioural issues are impeding competition. Based largely on the results of the Consumer Survey, this chapter considers customers' willingness to switch retailers or switch to a market contract with their current retailer. It also examines the extent to which customers feel they have access to and understand information provided in relation to market contracts and their level of satisfaction with retail competition. Where relevant, results of the Consumer Survey are compared to the results of the survey undertaken as part of the 2004 ESC Review to show how customer experience and behaviour has changed as energy retail competition has progressed.

## **6.1 Switching behaviour**

An important measure of customer participation is the rate at which customers are actively switching to and between market contracts. Where a sufficient number of customers are willing to switch to contracts with more attractive price or non-price terms, retailers are likely to be constrained in the extent to which they can retain or exercise market power in respect of any particular customer group.

When switching to or between market contracts, customers may switch to a new retailer or from the standing offer to a market contract with their host retailer (this is

referred to as internal switching). Evidence of both types of switching is important for effective competition. That is, in an effectively competitive market, customer switching patterns should reflect both the acquisition strategies of new retailers, as well as the retention strategies of host retailers. Moderate to high rates of internal switching suggest that host retailers are constrained by the conduct of new entrants (i.e. they need to actively market to their own standing offer customer base in order to maintain their market share).

This section considers the current rate and trend of customer switching to market contracts, including those between retailers and those internal to host retailers. It also considers the types of customers that switch and the reasons given by customers for switching or not switching to a market contract.

### **6.1.1 Gross, internal and net switching rates**

As at 31 December 2006, around 62 per cent of domestic and 43 per cent of small business customers in Victoria had switched from the standing offer to an electricity market contract. Of those customers with mains gas connected, around 60 per cent of domestic and 31 per cent of small business customers had also switched to a gas market contract.<sup>213</sup>

#### **6.1.1.1 Electricity**

Figure 6.1 below shows the number of gross and internal switches per quarter for all small electricity customers for the four year period from July 2003 to June 2007. Gross switching refers to the total number of completed transfers between retailers and includes all instances where there has been a change in the retailer allocated to a connection point, regardless of the reason for that change (i.e. it includes switches that occur when a customer moves house but does not switch retailer as well as instances of multiple switching<sup>214</sup>). Internal switching refers to the number of

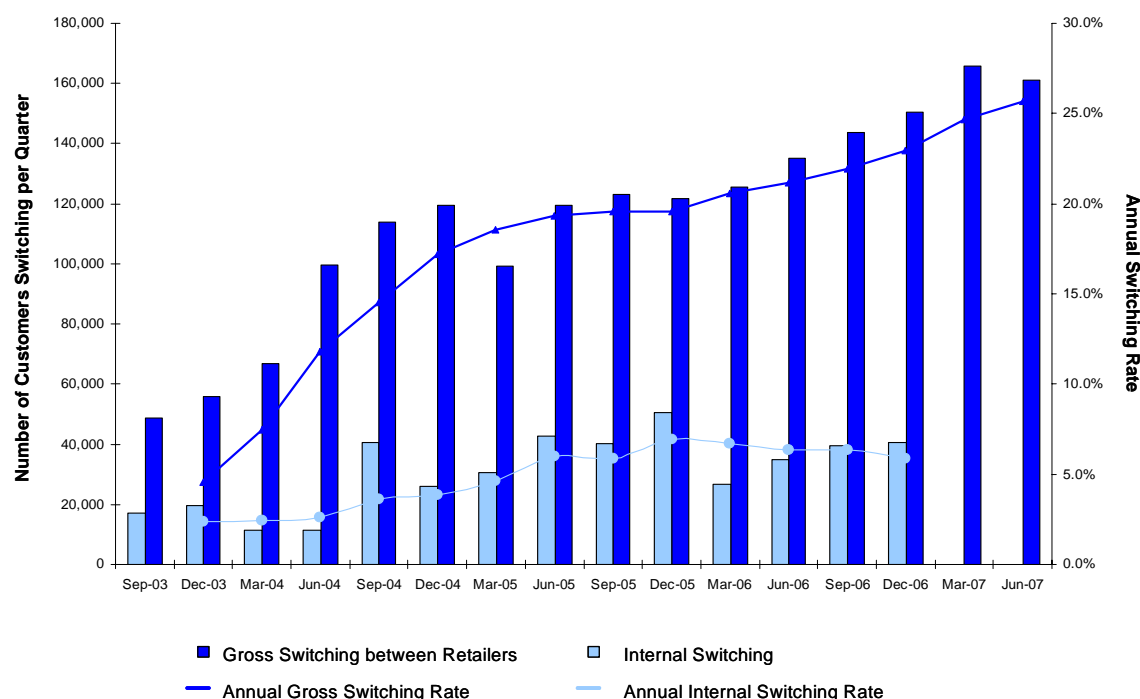
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<sup>213</sup> This calculation is based on data provided by retailers in the context of the Victorian Review. The data provided by retailers differs from the switching rates observed in the Commission's customer survey. Responses to the customer survey suggest that 60 per cent of domestic and 54 per cent of small business customers have switched to an electricity market contract and 42 per cent of domestic and 38 per cent of small business customers have switched to a gas market contract: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, pp. 34-35. These differences may reflect sampling errors in the consumer survey and non-sampling errors in both sets of data.

<sup>214</sup> Transfers that occur when a customer moves into new premises may not reflect a switch of retailer. Where a customer moves into premises supplied by a retailer other than the retailer with whom they have a contract, a transfer must be arranged if the customer wishes to continue to be supplied under the contract with its current retailer. Given that gross switching includes those customers that have moved premises but have not switched retailer as well as those customers that have switched retailer more than once, the number of gross switches is inflated. Not all transfers that occur when a customer moves premises will be due to the customer wanting to remain with their current retailer. It is reasonable to expect that a proportion of customers that move premises will change retailer at the same time.

customers that have switched from a standing offer to a market contract with their host retailer.

**Figure 6.1 Gross and internal switching for small electricity customers 2004-2007**



Sources: Gross switching data supplied by NEMMCO. Internal switching data provided by tier 1 retailers AGL, Origin and TRUenergy

Notes: Complete internal switching data was not available for the quarter ended 31 March 2007

As shown in Figure 6.1, there has been a relatively steady increase in the annual gross switching rate from 12 per cent for the year ended 30 June 2004 (270,770 transfers) to 26 per cent for the year ended 30 June 2007 (621,627 transfers).<sup>215</sup> Over this time the proportion of transfers due to customer move-ins remained relatively steady at around 30 per cent, suggesting that the increase in the rate of gross switching was largely due to customers actively switching between retailers. The rate of internal switching also increased from 2.4 per cent in 2004 (54,889 transfers) to 6.8 per cent in 2007 (141,492 transfers), though this rate has shown a slight decline since 2005.<sup>216</sup>

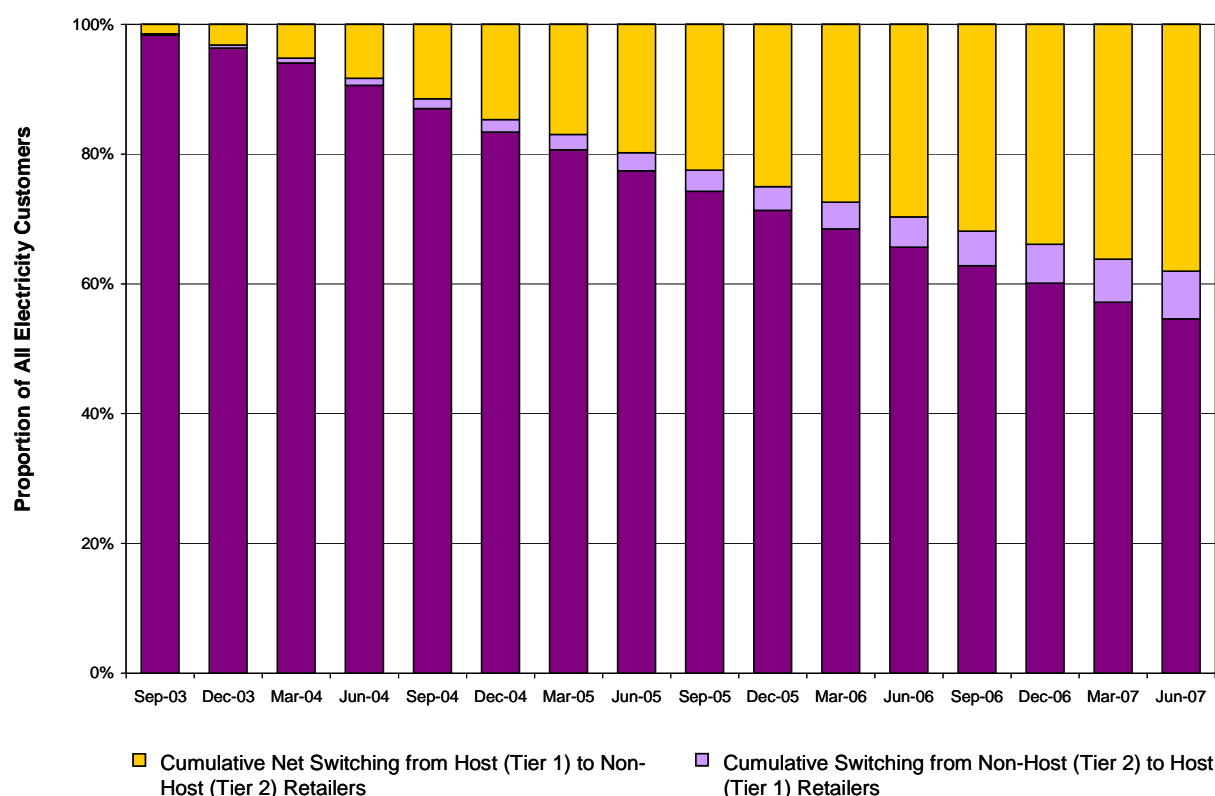
<sup>215</sup> The annual gross switching rate is calculated as the number of gross switches as a percentage of the average customer base for that year. Figure 6.1 shows the annual gross switching rate for each quarter for the period December 2003 to June 2007.

<sup>216</sup> The annual internal switching rate is calculated as the number of all standing offer customers that have transferred to a market contract with their first-tier retailer as a percentage of the average customer base of those retailers for that year. The internal switching rate for 2007 was calculated for the 12 month period to the end of January 2007 as data was not available beyond this date.

Of those customers that have switched retailer, most have switched only once, although the rate of multiple switching is significant. Of the customers who participated in the Consumer Survey and who had switched electricity retailer, 66 per cent of domestic and 72 per cent of small business customers said they had switched once, 19 per cent of domestic and 18 per cent of small business customers said they had switched twice and 11 per cent of domestic and 7 per cent of small business customers said they had switched a total of three times.

Figure 6.2 below shows the cumulative rate of net switching from a Tier 1 retailer to a Tier 2 retailer over the four year period from 2003 to 2007.<sup>217</sup> The figure provides some indication of how the cumulative customer share of host retailers has diminished over time as customers have switched to market contracts with new retailers.

**Figure 6.2 Cumulative net switching for small electricity customers 2004-2007**



Sources: Gross switching data supplied by NEMMCO

Notes: Cumulative net switching from Tier 1 to Tier 2 retailers is calculated as cumulative switches from Tier 1 to Tier 2 retailers less cumulative switches from Tier 2 back to Tier 1 retailers.

<sup>217</sup> A Tier 1 retailer is the retailer responsible under the EIA or the GIA for the supply of electricity or gas (as appropriate) to franchise customers in the geographic supply area allocated to that retailer. There is only one Tier 1 retailer for a given supply area. All other retailers who compete for customers in that supply area (including the Tier 1 retailers from other supply areas) are called Tier 2 retailers.

While not a perfect indicator of market share<sup>218</sup>, the data does suggest that up to 40 per cent of domestic or small business electricity customers in Victoria had switched to and remained on a market contract with a retailer other than their Tier 1 retailer by 30 June 2007 and that up to 10 per cent had switched to a Tier 2 retailer and then back to either the standing offer or a market contract with their Tier 1 retailer by 30 June 2007.<sup>219</sup> As shown in Figure 6.2, the rate of net switching from Tier 1 to Tier 2 retailers has been consistent over time and does not appear to be slowing.

#### 6.1.1.2 Gas

Switching rates to and between gas market contracts are lower than those for electricity but are nonetheless substantial. Figure 6.3 below shows the number of gross and internal switches per quarter for all small gas customers for the four years to June 2007.<sup>220</sup>

As is the case for electricity, the annual gross switching rate has steadily increased from 12 per cent for the year ended 30 June 2004 (190,242 transfers) to 21 per cent for the year ended 30 June 2007 (359,813 transfers).<sup>221</sup> The rate of internal switching has also increased from 8 per cent in 2004 (136,155 transfers) to 11.5 per cent in 2007 (193,625 transfers).<sup>222</sup>

Again, most gas customers that have switched retailer have done so only once, although the rate of multiple switching is significant. Of all customers surveyed that had switched gas retailer, 71 per cent of domestic and 72 per cent of small business

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<sup>218</sup> Switching data is not a precise measure of market share for a number of reasons. First, it does not include data for the period to 30 June 2003. It is understood that approximately 190,000 gross switches occurred up to this date. This represents around 8 per cent of all NMIs as at 30 June 2007. While the majority of customer transfers are likely to be due to customers switching from the Tier 1 to a Tier 2 retailer, some will be due to move-ins where the customer that previously occupied the residence was supplied by the Tier 1 retailer and continues to be supplied by the Tier 1 retailer after the move (i.e. a switch will be recorded where neither the current tenant nor the previous tenant switched from the host to a non-host retailer). Given the proportion of all transfers that are due to customer move-ins (around 30 per cent), the proportion of these customers is likely to be small.

<sup>219</sup> It is not possible to determine how many of those customers that have switched from a second tier retailer to a first tier retailer have switched back to the standing offer or a market contract with their host retailer. It is also not possible to determine whether these switches were due to customer move-ins where the customer chose not to switch retailer (ie, they moved into a premises not supplied by the host retailer).

<sup>220</sup> Figures for small gas customers refers to consumption of less than 10 TJ, due to the delineation in VENCORP data regarding interval and basic meters.

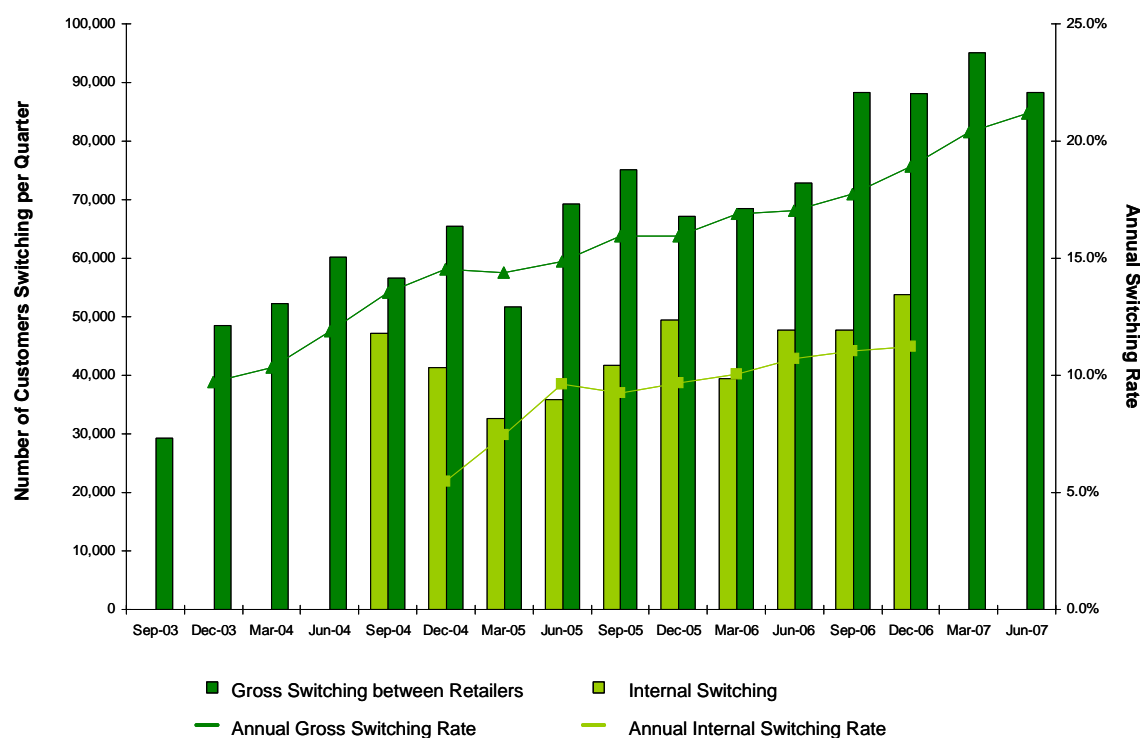
<sup>221</sup> The annual gross switching rate is calculated as the number of gross switches as a percentage of the average customer base for that year. Due to a data extraction error, completed transfers for May to July 2006 were unavailable.

<sup>222</sup> The annual internal switching rate is calculated as the number of all standing offer customers that have transferred to a market contract with their host retailer as a percentage of the average customer base for that year. The internal switching rate for 2007 was calculated for the 12 months to January 2007 as data was not available beyond this date.



gas customers said they had switched once, 15 per cent of domestic and 23 per cent of small business customers said they had switched twice and 10 per cent of domestic and 3 per cent of small business customers said they had switched three times.

**Figure 6.3 Gross and internal switching for small gas customers 2004-2007**



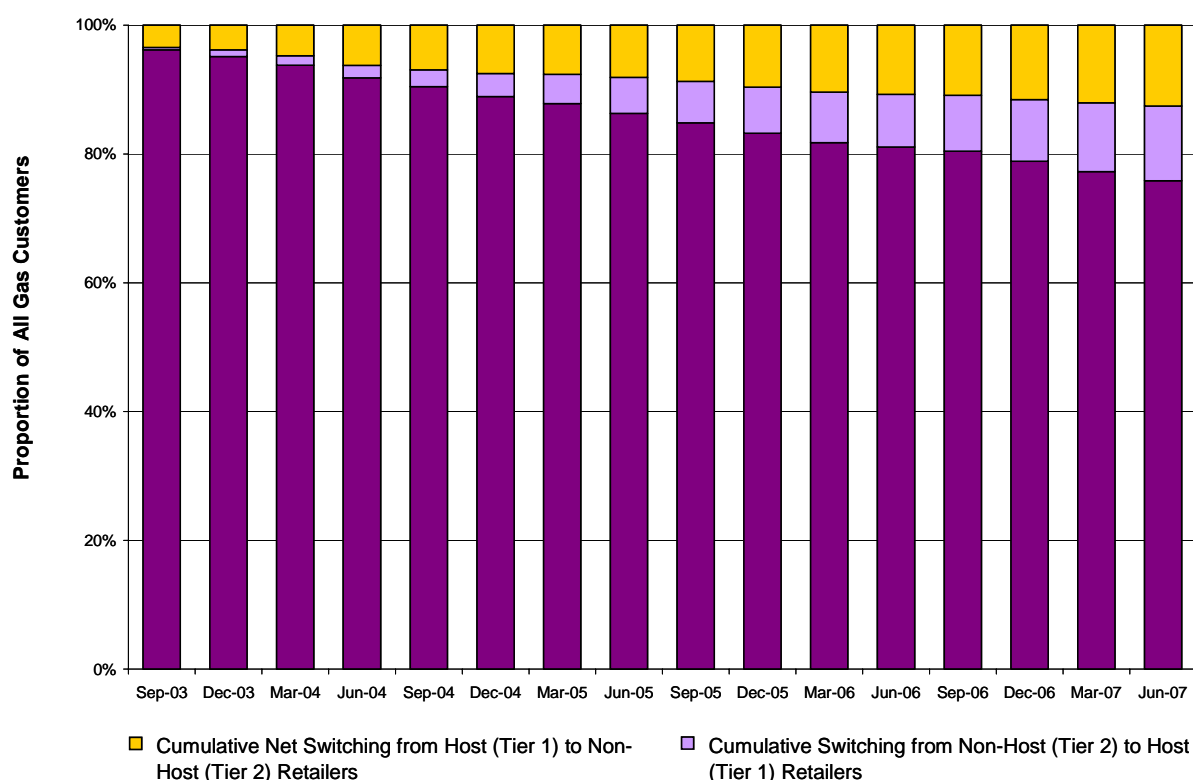
Sources: Gross switching data supplied by VENCorp. Internal switching data provided by tier 1 retailers AGL, Origin and TRUenergy

Notes: Complete internal switching data was not available for the period prior to 1 July 2004 or for the quarter ended 31 March 2007

The proportion of customers that have switched from their Tier 1 retailer to a Tier 2 retailer has also increased over time. As shown in Figure 6.4, switching data suggests that up to 10 per cent of small gas customers have switched from the Tier 1 retailer to a Tier 2 retailer since July 2003 and up to 10 per cent have switched to a Tier 2 retailer then back to their host retailer by 30 June 2007. Again, this data is not a perfect measure of customer share but does provide some indication of how the customer share of host retailers has diminished over time.<sup>223</sup>

<sup>223</sup> Note that the cumulative net switching data displayed in Figure 6.4 above does not include those customers that switched from a Tier 1 to a Tier 2 retailer prior to 30 June 2003. It is understood that around 90,000 gross switches occurred up to this date. This represents 5 per cent of all DSPs as at 30 June 2007.

**Figure 6.4 Cumulative net switching for small gas customers 2004-2007**



Sources: Gross switching data supplied by VenCorp

Notes: Cumulative net switching from Tier 1 to Tier 2 retailers is calculated as cumulative switches from Tier 1 to Tier 2 retailers less cumulative switches from Tier 2 back to Tier 1 retailers.

Overall, the switching rates observed for both electricity and gas suggest that when faced with an attractive offer by a door-to-door or telesales representative, a large proportion of customers will switch. As discussed in section 6.3 below, those customers that have switched to market contracts are generally of the view that the agreements they entered into met their expectations.<sup>224</sup>

### 6.1.1.3 International comparison

Gross switching rates of around 20-26 per cent as seen in Victoria are high when compared to international standards. Research recently undertaken by First Data Utilities and VaasaETT indicates that Victoria had the highest gross switching rate of

<sup>224</sup> Those domestic customers surveyed that had switched to an electricity market contract gave an average rating of 7.8 for the extent to which the agreement met their expectations. Small business customers gave an average rating of 6.9: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, pp. 36-37.

anywhere in the world in 2006, including Great Britain, where energy customers have been contestable since 1998.<sup>225</sup>

In their report, the researchers rank over 30 contestable energy markets by reference to switching rates and classify them into four categories:<sup>226</sup>

- hot market – over 15 per cent of customers switching per year;
- active market – between 5 per cent and 15 per cent of customers switching per year;
- slow market – between 1 per cent and 5 per cent of customers switching per year;
- dormant market – less than 1 per cent of customers switching per year.

Of the markets analysed, only three (Victoria, Great Britain and South Australia) had an annual gross switching rate in excess of 15 per cent. The majority of other markets were considered either active or dormant. Active markets included, in order, Texas, Norway, New South Wales, New Zealand, Sweden, Finland, the Netherlands, and Flanders (Belgium). Like Victoria, most of these markets have been open to competition for at least five years.

More than half of the markets considered were classified as dormant with switching rates of less than 1 per cent per year. These markets included Austria, Denmark, Ireland, Portugal, Spain and almost all North American markets (with the exception of Texas). The authors cite a number of factors that are likely to have inhibited successful retail competition in these markets including the role of established retailers as “last resort” suppliers, the retention of certain retail functions with established businesses, inadequate regulated retail margins in an environment of increasing wholesale costs and continued vertical integration of retail and distribution functions.<sup>227</sup>

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<sup>225</sup> First Data Utilities and VaasaETT, Utility Customer Switching Research Project, *World Energy Retail Market Ranking*, 3rd edition, July 2007.

<sup>226</sup> The researchers note that the Project’s customer switching rate metric is calculated by dividing the number of customers who switched suppliers in a given period by the number of customers in the market.

<sup>227</sup> First Data Utilities and VaasaETT, Utility Customer Switching Research Project, *World Energy Retail Market Ranking*, 3<sup>rd</sup> edition, July 2007, p. 6. It is interesting to note that a number of the US states classified as dormant employ a regulated-competitive hybrid market structure, where new entrants are required to compete with vertically integrated established utilities. While new entrants are free to market their offers, the established utility generally retains control over billing, payment and customer service retail functions. This hybrid structure effectively places a barrier between new entrant retailers and their customers and may be a factor which has impeded customer switching in these markets.

### 6.1.2 Characteristics of switching customers

While the rate of customer switching in Victoria is relatively high by international standards, it is still relevant to consider whether switching customers have particular distinguishing features compared to the characteristics of those not participating in the competitive market. For example, certain groups of customers may not be participating due to either their relative costliness for a retailer to serve (e.g. due to low consumption or remote location), particular behavioural biases, or their personal circumstances (e.g. insufficient income, physical or intellectual disability). The circumstances of customers who are not benefiting fully from the competitive energy market and possible policy responses are considered in Chapter 9.

The Consumer Survey results show that some classes of customers are more likely than others to have switched to a market contract. Domestic customers most likely to have switched to an electricity market contract are those that:<sup>228</sup>

- live in regional centres (as opposed to Melbourne or rural areas) (68 per cent switched);
- live in rented accommodation (69 per cent switched);
- have a relatively high household incomes (i.e. over \$75,000 per annum) (66 per cent switched); and/or
- are under 40 years of age (65 per cent switched).

Domestic customers that are most likely to have switched to a gas market contract are those with a household income above \$50,000 per annum.<sup>229</sup>

In light of the above, there are some defining characteristics of customers that are more likely to be supplied under a standing offer for electricity and/or gas (i.e. more likely to be “non-switchers”). Customers supplied under a standing offer are more likely to:

- be unaware that they can choose their electricity retailer or have not been approached by an energy retailer;
- live in Melbourne or rural Victoria; and/or
- be over 70 years of age and/or retired.

As indicated in Chapters 4 and 5, the proportion of customers who are aware that they can choose their retailer and that have been contacted by a retailer is increasing and this trend is likely to continue. Accordingly, the number of customers that fall into the first category of customers more likely to be on a standing offer should

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<sup>228</sup> See Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 34.

<sup>229</sup> *Ibid*, p. 35.

gradually reduce as retail competition continues to develop and retailer marketing activity extends its reach. While the other characteristics of non-switchers are more common among standing offer customers, there is no evidence to suggest that customers that display these characteristics have been precluded from participating in the market. For example, only 42 per cent of domestic customers that live in Melbourne or in rural areas are supplied electricity under a standing offer. While this is greater than the equivalent proportion of regional customers (32 per cent), it does not suggest that the extent to which customers in Melbourne or in rural areas can participate in the market has been limited. Similarly, around 49 per cent of customers over 70 years of age are supplied electricity under the standing offer, compared to 39 per cent for those aged under 70.

The small business customers that are more likely than others to be supplied under a standing offer are those with low energy costs as a proportion of total business expenses (54 per cent electricity, 72 per cent gas) and those with more than 20 employees (64 per cent electricity, 90 per cent gas).<sup>230</sup> There is no evidence before the Commission to indicate that these customers are less able than others to participate in the market, however, they may be less willing to switch to a market contract given the administrative costs that would be incurred to achieve what may ultimately be a relatively small financial benefit.

On this basis, there is no evidence to suggest that any particular domestic or small business customer groups are being excluded from participating in competitive energy retailing. As customer awareness of competition increases and retailer marketing activity expands to reach more consumers, customer participation can be expected to increase further.

### 6.1.3 Reasons for switching or not switching

Most customers that have switched to a market contract have done so in response to the direct marketing initiatives of retailers. While few customers initiate contact with a retailer, over 70 per cent of all electricity and 40 per cent of all gas customers surveyed by the Commission had been contacted directly by a retailer either in person, by phone or by some other means since the commencement of FRC.<sup>231</sup>

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<sup>230</sup> *Ibid*, Table H, pp. 34–35.

<sup>231</sup> Only 10 per cent of domestic customers surveyed indicated that they had contacted an electricity retailer and 6 per cent a gas retailer over the last five years. Similarly, only 12 per cent of small business customers had approached an electricity retailer and 6 per cent a gas retailer. Of those domestic customers that had been contacted by an electricity or gas retailer, over 50 per cent had been contacted by a door-to-door sales representative and around 40 per cent contacted by phone. Small business customers were mostly contacted by an electricity retailer by phone (63 per cent) rather than by a door-to-door sales representative (33 per cent). The majority of customers that have contacted or have been contacted by a retailer have been made an offer (at least 68 per cent of domestic customers and 76% of small business customers): Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, pp. 23-25.

The most common reason cited by both domestic and small business customers for switching to a market contract is the offer of lower prices and the offer of green energy (which traditionally has been offered at prices higher than that of the standing offer). As shown in Table 6.1 below, almost 50 per cent of domestic and 70 per cent of small business customers surveyed that have switched to a market contract, cited having switched for these two reasons, with businesses more concerned about lower prices than green energy.

**Table 6.1 Reasons for switching or not switching**

	Domestic		Small Business	
	Electricity	Gas	Electricity	Gas
<b>Reason for Switching to a Retailer</b>				
<i>Market Contract Customers</i> <sup>1</sup>	62%	60%	43%	31%
Lower prices immediately or discount/cheaper	42%	N/A	58%	N/A
Offer of green energy	14%	N/A	10%	N/A
Other	46%	N/A	32%	N/A
<b>Reason for Not Switching to a Market Contract</b>				
<i>Standing Offer Customers</i> <sup>1</sup>	38%	40%	47%	69%
Just stayed with the same retailer	51%	45%	43%	40%
Don't know	15%	20%	22%	21%
Couldn't be bothered	13%	13%	8%	11%
Other	21%	22%	27%	28%

Source: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, pp. 42-44.

<sup>1</sup> Proportion of market contract and standing offer customers based on information provided by retailers, not the results of the consumer survey.

A number of submissions to the Issues Paper and the First Draft Report expressed concern that Victorian energy customers may be making poor switching decisions<sup>232</sup> and encouraged the Commission to undertake additional analysis to determine whether customers who had switched retailer in response to a lower price had, as a matter of fact, realised a saving.<sup>233</sup> To this end, the Commission was referred to a

<sup>232</sup> See the submissions to the First Draft Report from Alternative Technology Association (p. 3); Consumer Action Law Centre (p. 7); Consumer Utilities Advocacy Centre (pp. 3-4); St Vincent de Paul (p. 2); Victorian Council of Social Service (p. 3).

<sup>233</sup> See, for example, submissions to the Issues Paper from Consumer Utilities Advocacy Centre (p. 7); and Victorian Council of Social Service (p. 4). See submissions to the First Draft Report from the Centre for Consumer and Credit Law (p. 1); Consumer Action Law Centre (p. 1); Consumer Utilities Advocacy Centre (pp. 3-4); St Vincent de Paul (p. 2); Victorian Council of Social Service (p. 3).

study undertaken in the UK which sought to assess whether customers who switched solely to receive a lower price realised a welfare gain.<sup>234</sup>

In response to submissions, the Commission considered the appropriateness and relevance of conducting a similar study of Victorian energy customers as part of its assessment of the effectiveness of competition. Regardless of the difficulties the Commission identified in gathering relevant and timely information from both customers and retailers<sup>235</sup>, it concluded that the results of such a study were likely to be of limited use. While not all customers achieve *ex post* savings from switching retailers, it is unlikely that a decision to switch was not, at the time it was made, expected to make the consumer better off. As previously noted, the costs of searching for and acquiring additional information may be perceived to outweigh the benefits of having that information and, as such, consumers will rationally limit their search while accepting that they may not achieve the best outcomes available in the market.

Given the characteristics of retailer energy markets, i.e. a low involvement product and the presence of search costs, it is likely that Victorian consumers make similar mistakes to those in the UK. However, price regulation is unlikely to help consumers make better decisions. Indeed, the first UK study undertaken before price regulation was removed indicated similar error rates. Rather than regulate retail prices, problems associated with the pricing outcomes of poor switching decisions should be addressed through policies and regulations to improve the quality of information and to reduce search costs. Nevertheless, the Commission is cognisant of the relevance of asking those customers who had switched whether their market contract met their expectations. Accordingly, the Consumer Survey included several questions to this end.

Very few customers that switched to an electricity market contract indicated that the offer of a free gift was a primary motivator for switching (3 per cent). Similarly, loyalty bonuses or discounts for prompt payment were not considered to be significant for most customers in their decision to switch. Only 7 per cent of domestic and 2 per cent of small business customers on an electricity market contract cited one or more of these as a reason for switching to their current retailer.<sup>236</sup>

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<sup>234</sup> Chris M. Wilson and Catherine Waddams Price, "Do Consumers Switch to the Best Supplier?", CCP Working Paper 07-6, April 2007. The study found that 82 per cent of customers did not get the *best* deal and 31 per cent became worse off. However, these results also show that 18 per cent of customers realised perfect gains and 69 per cent of customers were at least as well, if not *better*, off after they switched. The Commission notes that the study did not find obvious evidence that mis-selling explains the inaccuracy of consumers' switching decisions which were more likely to be caused by pure decision errors, perhaps as a result of difficulties in interpreting tariff offerings.

<sup>235</sup> The Commission has no statutory information gathering powers and would be wholly reliant on co-operation from retailers, as well as retailers having the historical information necessary to determine the prices paid by customers before they switched and afterwards. In contrast, the UK requires retailers to publish all tariffs, thereby enabling Wilson and Waddams Price to locate the "before and after" tariffs for each consumer survey.

<sup>236</sup> Wilson and Waddams Price, "Do Consumers Switch to the Best Supplier?", CCP Working Paper 07-6, p. 44.

The majority of customers who chose not to switch to a market contract noted that they have either just stayed with their host retailer, they don't know why they haven't switched or they couldn't be bothered switching. This is reflective of either a lack of interest in energy products, status quo bias and/or the perception of significant search and/or switching costs among a proportion of customers. Approximately 30-35 per cent of electricity customers and 30-50 per cent of gas customers appear to display a bias toward the standing offer for these reasons.

A significant proportion of the customers that had not switched retailer (some of whom are on market contracts but most are on the standing offer) also noted that they liked their current retailer and for this reason chose not to change. Between 20-25 per cent of domestic customers and 16-18 per cent of small business customers that had not switched retailer gave this as a reason for not switching. This suggests that loyalty plays some part in switching for a proportion of all customers (less than 15 per cent). It is also reflective of a conscious decision by a proportion of the customers who remain on the standing offer to leave their existing supply arrangements unchanged. Accordingly, it should not be assumed that customers who fit into this category are not receiving, or are unable to receive, the benefits of effective competition.

The results of the Consumer Survey suggest that price competition between retailers and continued product innovation, particularly in regard to green energy products, will be important for customer participation going forward. The level of customer inaction also has the potential to impact on competition, particularly if retailers are capable of distinguishing standing offer customers who would and would not be willing to switch if presented with an attractive market offer.<sup>237</sup>

The evidence presented to the Commission through submissions to the Issues Paper and the results of the Consumer and Retailer Surveys reveal that the opportunity to take up dual fuel products is not a determinative factor in most customers' decisions to switch retailer or to enter into a market contract, particularly for small business customers. For example, Origin Energy's submission to the Issues Paper stated:<sup>238</sup>

"It is unclear to Origin how much customers value a dual fuel contract in their decision making. Anecdotally, some consumers do appear to like to consolidate their energy supply with one retailer, but this is not essential.

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<sup>237</sup> As discussed in Chapter 5, it is not clear that retailers are currently able to ascertain the propensity of a standing offer customer to switch. However, maintaining the standing offer may create or enhance retailers' ability to identify "non-switchers" i.e. infra-marginal customers. That is, the retailer is able to use the standing offer to identify those customers who have been unwilling to switch to a market contract, either due to a status quo bias or the existence of high perceived search and/or switching costs. As competition develops and a greater number of customers switch in response to the offer of discounts or as a result of retailers effectively reducing perceived switching costs, the proportion of customers that remain on the standing offer that have a true status quo bias will increase. Retailers who are able to distinguish customers that have a status quo bias and those that are willing to switch if offered a sufficient price discount may be able to exercise market power in the event that standing offer regulation is removed.

<sup>238</sup> Origin Energy, submission to the Issues Paper, p. 13.



Offering a single fuel does not seem to be an impediment to a retailer in gaining market share.”

Similarly, the Consumer Survey reveals that the opportunity to acquire gas and electricity from a single retailer was a reason for entering into a market contract for only 10 per cent of domestic customers. As one retailer noted, some customers do value the simplicity and efficiency of dual fuel contracts but this needs to be balanced against concern about financial stress imposed by a large quarterly energy bill. Only 3 per cent of business customers on market contracts switched to take advantage of a dual fuel product.

As discussed in Chapter 5, direct marketing by retailers is likely to continue to be an important feature of the market and will help to reduce the perceived cost of switching for a number of customers. However, there may continue to be a number of customers who face impediments to switching either because of inherent characteristics such as a status quo bias or their personal circumstances such as income or credit history. The circumstances facing these customers are discussed in more detail in Chapter 9.

## **6.2 Access to and understanding of contract information**

Access to accurate and relevant information about the tariffs, terms and conditions of market contracts is necessary for the development of effective competition in energy retailing. Without access to such information, customers are unable to make an informed choice in relation to their supply options. Where this is the case, market outcomes may be sub-optimal and retailers will be better able to maintain and exercise some degree of market power.

This section considers the type of information that customers currently use when making their supply decisions as well as their understanding of this information.

### **6.2.1 Sources of information used**

Table 6.2 below shows the proportion of domestic and small business customers who used at least one source of information in making their decision to purchase energy from their current supplier.

**Table 6.2 Sources of information used by electricity market contract and standing offer customers**

	Domestic		Small Business	
	Market Contract	Standing Offer	Market Contract	Standing Offer
Provided by person who came to my door	20%	7%	17%	3%
Provided by person who phoned me	9%	4%	13%	4%
Retailer	13%	8%	17%	5%
Got something in the mail	7%	5%	7%	2%
Internet	7%	4%	6%	4%
TV, Radio, newspaper or Magazines	5%	4%	3%	3%
Other	22%	14%	17%	9%
Customers that used at least one source of information	74%	42%	71%	28%
Customers that did not use information or did not know what information they used	26%	58%	29%	72%

Source: Consumer Survey results.

The most common source of information used by market contract customers is that provided by door-to-door and telesales representatives and from retailers more generally. At least 30 per cent of electricity market contract customers indicated that they had used information provided via these two sales channels. An additional 13 per cent of domestic and 17 per cent of small business customers indicated they used information from a retailer more generally. It is unclear whether this information was offered by the retailer or provided at the request of the customer.<sup>239</sup>

The Consumer Survey did not ask customers who had switched to a market contract or between retailers whether they had regard to the standing offer price in making the decision. However, submissions to the First Draft Report identified the standing offer price as an important point of comparison for customers in evaluating retail offers. The Consumer Action Law Centre submitted that without the standing offer price, “consumers will have no confidence that they are receiving the best deal.”<sup>240</sup> The current pricing structure for market contracts (i.e. a percentage discount off the standing offer price) indicates that, holding all else constant and assuming accurate pricing information is provided, a customer who switches from a standing offer to a market contract will realise savings. The presence or existence of the standing offer

<sup>239</sup> Given that only a relatively small proportion of customers have contacted a retailer directly, it is likely that this information was provided at the instigation of the retailer or was requested by the customer following contact initiated by the retailer.

<sup>240</sup> Consumer Action Law Centre, submission to the First Draft Report, p. 8. See also submissions to the First Draft Report from Alternative Technology Association (p. 2) and Saint Vincent de Paul (p. 3).

price offers no assistance to customers who switch between market contracts and sustain welfare losses. Further, as noted in Chapter 5, the standing offer price will become increasingly redundant as a comparative tool as the proportion of customers on market contracts increases.

Standing offer customers are less likely than market contract customers to have been contacted by a retailer.<sup>241</sup> They are consequently less likely to have been provided with information or to have considered information made available by retailers. They are also less likely to have used other sources of information such as that available on the internet or information from friends or colleagues.

The significant proportion of standing offer customers that used no information in making their supply decision is reflective of the nature of demand for energy supply and the relatively low level of interest among customers in investigating their supply options. As more and more consumers are contacted by retailers and provided with information about competing offers, these trends should change.

Very few market contract customers used more than one source of information when making the decision to switch.<sup>242</sup> This suggests that when switching, customers do not shop around or make extensive price comparisons.<sup>243</sup> The relatively large proportion of customers that appear to rely solely on information provided to them by retailers in making their decision to switch suggests that the direct marketing efforts of retailers is an efficient method for encourage switching which has enhanced competitive outcomes from the perspective of both retailers and customers alike.

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<sup>241</sup> Around 62 per cent of domestic and 59 per cent of small business customers on a standing offer for electricity have been contacted by an electricity retailer, compared to 81 per cent and 83 per cent of market contract customers respectively. Around 31 per cent of domestic and 29 per cent of small business customers on a standing offer for gas have been contacted by a gas retailer, compared to 64 per cent and 59 per cent of domestic and small business market contract customers respectively: Consumer Survey.

<sup>242</sup> Only 11 per cent of domestic and 13 per cent of small business customers that have switched to a market contract used more than one source of information. This assumes that those customers that indicated they used some source of information in response to the Consumer Survey named a maximum of two sources. If a number of respondents named more than two sources, the proportion of customers that have used more than one source of information would be lower than this.

<sup>243</sup> Very few customers (5 per cent of domestic and 4 per cent of small business customers) said that they had compared bills or rates when making the decision to switch. This is consistent with a view put forward by EWOV. In its submission to the Issues Paper, EWOV noted that staff that had worked on marketing reports indicated that they had not come across a case in which customers actually compared two offers before making a choice, although they may have compared the offered rates with their current rates: Energy and Water Ombudsman (Victoria), submission to the Issues Paper, p. 8.

### 6.2.2 Understanding the available information

Submissions from some consumer groups to the Issues Paper suggested that adequate information regarding market contracts is hard to find and that customers find it difficult to understand. As noted by the Victorian Council of Social Service:<sup>244</sup>

“...it is very difficult for consumers to access the type of information necessary to make an informed choice. Notwithstanding the difficulty in finding tariff information without actually requesting an offer from a retailer ... anyone wanting to make a considered choice needs a working understanding of how energy is priced and sold, plenty of time, and access to the internet. If an offer is received from a retailer, it is still difficult for someone without specialist knowledge to make a price comparison unless they know about and use the comparator on the ESC’s website.”

A number of consumer groups also expressed concern that the roll-out of advanced meters will increase tariff complexity and create new obstacles to customers seeking to identify the contact best suited to their circumstances.<sup>245</sup>

The results of the Consumer Survey support the view that a significant proportion of customers do not find information provided in relation to market contracts easy to understand and compare with their current arrangements. As noted above, most customers do not actively look for information and instead rely primarily on the offer summaries and product information statements provided by retailers. Despite the fact that retailers are bound by guidelines requiring them to include specific content in the preparation of these documents, customers do not appear to have any greater understanding of offers now than they did a few years ago.

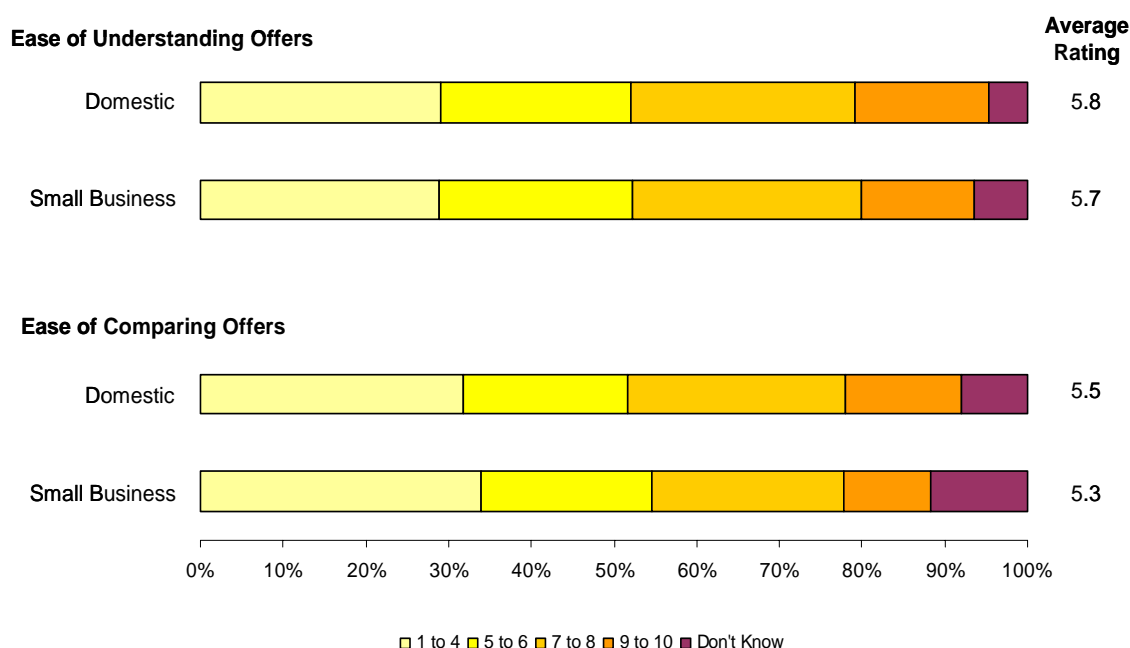
As shown in Figure 6.5 below, of those customers that had received an offer from a retailer, around a third to a half indicated that it was either not very easy to understand or was not easy to compare with the energy supply arrangements that they currently had.

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<sup>244</sup> Victorian Council of Social Service, submission to the Issues Paper, p. 5.

<sup>245</sup> Consumer Action Law Centre, submission to the First Draft Report, p. 9; Consumer Utilities Action Centre, submission to the First Draft Report, p. 5; Saint Vincent de Paul, submission to the First Draft Report, p. 3.

**Figure 6.5 Ease of understanding and comparing offers**



Source: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, pp. 27-28.

Since August 2005, retailers have been required to publish product information statements on their websites and provide customers with offer summaries before signing a contract. Approximately 40 per cent of domestic and small business customers surveyed indicated that the current offers made by retailers were easier to understand than they were a few years ago.<sup>246</sup>

While a large proportion of customers do not consider market offers easy to understand and compare, this does not appear to have posed a significant barrier to customer switching as evidenced in section 6.1 above. The results of the Consumer Survey suggest that very few of the customers that have not switched to a market contract (2-3 per cent of domestic and 1 per cent of small business customers) chose to remain on the standing offer because of a lack of information about market contracts.<sup>247</sup>

The Consumer Survey results also suggest that customers are generally more confident in being able to access the information they need in making decisions in

<sup>246</sup> Around 36 per cent of domestic and 39 per cent of small business customers disagreed that offers were easier to understand compared to a few years ago: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 29.

<sup>247</sup> *Ibid*, p. 42. Note that responses “didn’t know I could” and “need more information” have been added together in Table 12.

regard to their energy supply.<sup>248</sup> They also appear to be significantly more confident in their ability to choose their own electricity or gas retailer.<sup>249</sup>

The apparent increase in consumer confidence over the last three years may simply reflect the fact that a much larger number of customers have now been contacted by a retailer and have therefore been provided with some form of information. It may also be possible that the provision of information in accordance with the Product Disclosure Guideline and Marketing Code has improved customer views as to the quality or accuracy of information available, thereby improving customer confidence in their ability to choose their retailer even if they do not have a detailed understanding of the information they have been provided with.

Whatever the case, the fact that there has been no apparent increase in either the degree of understanding or ease of comparing market offers raises questions about the effectiveness of the mandatory information disclosure requirements imposed by the Product Disclosure Guideline. This does not necessarily mean that the information requirements are too onerous or poorly designed given the nature of energy tariff structures. Rather, it may reflect the fact that a large proportion of customers are not willing to invest the time and effort required to adequately understand the information provided (i.e. to read through product information statements or offer summaries and calculate the potential savings available to them based on their last energy bill). It is also possible that the information disclosure required by regulation may be contributing to some “information overload”, hence reducing customers’ ability to access the most useful information. This trend has been observed in other sectors, including financial services.<sup>250</sup> It may also be the case that some of the customers that do not find offers easy to understand or compare, understand them well enough to be confident that they will achieve some level of savings or some other net benefit by switching.<sup>251</sup>

Whether or not the general lack of understanding of contract information poses a significant problem for competition largely depends on whether the informed decisions of those customers with sufficient understanding of such contracts

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<sup>248</sup> Domestic customers gave an average rating of 7.1 out of 10 for their confidence in being able to access the information they need, up from 5.9 in 2004. Small business customers gave this factor an average rating of 6.5: *Ibid*, p.51.

<sup>249</sup> Domestic customers gave an average confidence rating of 7.6 in 2007, up from 6.4 in 2002 and 6.1 in 2004. Responses by small business customers show a similar pattern with an average confidence rating of 7.3 in 2007, up from 6.6 in 2002 and 6.3 in 2004: *Ibid*, p.50. Interestingly, the majority of those customers that indicated they were not confident in being able to access the information they need or in switching retailer, suggested that the provision of more information that is easy to understand about costs and prices as well as the switching process would improve their confidence.

<sup>250</sup> Simon Hoyle, “With documents, smaller is better”, *Sydney Morning Herald*, 3 November 2007.

<sup>251</sup> For example, it may be the case that some customers are capable of assessing whether, on the whole, they would be better off under a market contract compared to their current arrangements. However, they do not consider the information they are provided easy to understand or compare that they cannot calculate the exact savings they would make over the term of the contract, particularly if the contract involves establishment fees, discounts for prompt payment, loyalty bonuses or termination fees.

constrains the behaviour of retailers. If enough customers have sufficient understanding of the implications of different offers and are willing to switch, retailers will face continued pressure to develop competitive market offers that would benefit a wide range of customers. In such circumstances, even those customers who do not understand the offers being made but choose to switch anyway, are likely to switch to a contract. However, if retailers are able to differentiate between well informed and ill-informed customers, retailers may be able to persuade customers that do not understand contract information to agree to contracts that either do not provide them with the greatest net benefit or may even make them worse-off. On the basis of the analysis contained in Chapter 5, the Commission has found no evidence of such discrimination.

Even where some customers make what appear, *ex post*, to be ill-informed decisions in relation to their energy supply, this does not necessarily mean that competition for these customers is not effective. Customers that switch to contracts that make them better off but do not provide them with the greatest possible savings may simply be making a rational utility maximising decision given the existence of search costs (i.e. the customer may know they may not be getting the best deal but consider the cost of looking for other offers to be more effort than it is worth). Some customers may also place greater value on smaller gains received earlier in the contract and therefore have a preference for contracts that involve the receipt of a free gift, even though they may end up paying more for their energy over the life of the contract.

A significant amount of information is provided by retailers both on the internet and to customers directly before they sign a contract. Over 70 per cent of customers that switch to market contracts use this information when making their decision to switch. Even though a relatively large proportion of customers do not consider the information they are provided easy to understand, this does not appear to have affected switching rates and customers appear to have sufficient understanding of market offers to feel confident in making choices and switching between retail offers. The purported difficulty customers face in understanding information may simply reflect the two-part, step-change structure of energy tariffs and the extent to which this complicates the calculation of energy bills compared to a single flat or variable tariff.<sup>252</sup> In a retail environment where price is regulated, market offers generally mimic the structure of the standing offer. That is, the continued use of more complicated tariff structures is a reflection of the current price regulation arrangements and the price structure they adopt. As noted in Chapter 5, Ofgem recently reported that around 9 million electricity and gas accounts in the UK (approximately 20 per cent of all energy accounts) now take supply under green, fixed price or online deals.<sup>253</sup>

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<sup>252</sup> Tariffs generally have a fixed and variable component (i.e. they are two-part) with the variable charge either increasing or decreasing as consumption increases (i.e. the variable charge is subject to step-changes. In the Origin (Citipower) and Origin (Powercor) distribution areas, the variable charge increases with increases in energy consumption. In the TRUenergy network area, the variable charge decreases with increases in energy consumption. There are also often different charges for consumption during peak and off-peak times.

<sup>253</sup> Ofgem, *Domestic Retail Market Report*, June 2007, p. 12.

### 6.3 Satisfaction with FRC

Customer satisfaction with market outcomes is also an indicator of the extent to which competition is effective. Even though customers may not consider the information they receive in relation to market contracts easy to understand, if they are largely satisfied with their choices *ex post*, this is indicative of effective competition at work.

The vast majority of customers (79 per cent of domestic and 76 per cent of small business customers) believe that the introduction of retail competition has been a positive development, citing increased choice, lower prices and a more competitive market as the primary reason for this view.<sup>254</sup> Of those customers that switched on the basis of market offers, most considered the offer to have met their needs, although the relatively modest average ratings of 6.1 for domestic and 5.6 for small business customers suggest there is room for improvement in the design of offers.<sup>255</sup> Most customers consider there to be a greater variety of offers available now compared to a couple of years ago and a large proportion (around 45 per cent) consider these offers to better meet their needs.<sup>256</sup>

Experience with switching has also been positive with customers giving an average rating of between 7 and 8.3 for ease of organising, length of time it took to put a market contract in place and the extent to which the contract met the customer's expectations.<sup>257</sup>

Overall, these results suggest that customers are satisfied with the outcomes of retail competition, although the design of market offers could be improved. While it is unclear what improvements consumers would like to see, the general lack of clear understanding of market offers suggests that simplified tariff structures may be one such improvement. This could be facilitated by the removal of standing offer price regulation.

### 6.4 Commission's findings

The Commission's analysis indicates that while customers do not generally initiate extensive search activity on their own behalf, consumers are willing to participate in the market by switching in response to the direct marketing initiatives of retailers, particularly in response to offers of lower prices. In fact, recent research indicates that Victoria has the highest switching rate of any energy retail market in the world, with around 60 per cent of all small customers having switched to a market contract since the introduction of competition five years ago.

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<sup>254</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 59.

<sup>255</sup> *Ibid*, pp. 27-28.

<sup>256</sup> Note that around 24 per cent of domestic and 27 per cent of small business customers did not believe that offer better suit their needs now compared to a few years ago: *Ibid*, p. 29.

<sup>257</sup> *Ibid*, pp. 36-37.



While switching was initially focused on movements from the standing offer to market contracts, a growing number of customers are now switching between market contracts with different retailers. The growing rate of multiple switching suggests that retailers face continued pressure to develop and market attractive offers in order to retain customers at the end of their contract term. The fact that consumers have not generally experienced significant problems when switching retailers suggests this pressure is unlikely to abate as a result of consumers withdrawing from active participation in the market.

There is no evidence to suggest that any particular customer group has been precluded from participation in the market or that information constraints have posed a barrier to customer switching. Even though customers do not purport to have better understanding of contract information now than they did three years ago, very few customers have chosen not to switch to a market contract because of this. Given the general structure of energy tariffs (i.e. prices are generally structured as two-part tariffs with changes to the variable rate as consumption increases), improving customer understanding of energy pricing is likely to be a difficult task for both retailers and regulators alike.

Overall, most customers are satisfied with the outcomes of retail competition in terms of price outcomes, the variety of offers available and the switching process. However, improvements could be made to the design of offers.

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## 7 Conditions for Entry, Expansion and Exit

This chapter focuses on the third of the Commission's three key strands of analysis: the impact of entry conditions on competition, including the extent to which new entry or potential new entry constrains retailer behaviour.

A new entrant who can establish itself, or a retailer that can expand its existing business, within a reasonable period of time and on a sufficient scale can impose a competitive discipline on its competitors. This discipline constrains the pricing and output decisions of other retailers, encouraging them to supply customers with a better price-product-service package than their rivals and potential rivals. It also encourages businesses to facilitate the flow of information about their products to consumers, who exercise choice on the basis of this information. Conditions that enable a retailer to establish or expand its energy retailing business and impose constraints of this nature on retailers encourage effective competition.

Conversely, where the conditions for new entry or expansion are unfavourable, retailers' behaviour is less constrained. This can lead to one or more retailers accumulating market power, resulting in prices being maintained above competitive levels, and/or output and service delivery being below competitive levels. The absence of competitive discipline may also lead to a failure by retailers to distribute to customers the information that is necessary to enable them to make informed decisions about their energy supply. Market conditions that protect retailers from the threat of new entry and expansion can stifle the development of effective competition.<sup>258</sup>

This chapter sets out the Commission's assessment of the conditions for entry, expansion and exit for energy retailing in Victoria. The Commission's analysis in this chapter is an integral part of its ultimate assessment of the effectiveness of competition which is set out in Chapter 2.

Chapter 7 divides the discussion of the Commission's analysis into two sections dealing with:

- non-regulatory market conditions for entry into, expansion within and exit from energy retailing (**Section 7.1**); and
- the legislative and regulatory structure for retailing energy, which can impact on the incentives for and cost of entry and expansion in Victorian energy retailing operations (**Section 7.2**).

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<sup>258</sup> However, it is important to note that even in the presence of entry barriers, there can still be effective competition, providing there are enough suppliers actively competing with each other and consumers willing to engage with competitive supply.

## 7.1 Non-regulatory conditions for entry, expansion and exit

A barrier to entry refers to any market characteristic or condition that places an efficient potential new entrant business at a disadvantage relative to an established business. A barrier to entry does not properly include a cost or other impediment that applies more or less equally to any party wanting to participate in the retail market, irrespective of whether it is an established retailer or a new retailer. Barriers to entry are an important element of an assessment of the effectiveness of competition because, where they are high, new entrants will not be encouraged to enter the market and erode any excess profits. As a result, the behaviour of the participants already in the market will not be constrained by the threat or actual entry of new participants.

Once a business has begun trading, it may also face costs or impediments that prevent it from expanding, or limit its ability to expand within or exit from the industry relative to its established competitors. These restrictions are known respectively as barriers to expansion and exit. Barriers to expansion exist where fringe or niche entry may be possible but there are obstacles to expanding to a size that would allow a new entrant to compete effectively against larger, more established businesses. In such circumstances, established large retailers may still not be constrained by the threat of entry. Barriers to exit can affect entry decisions if the costs of exiting the market are so prohibitive that the incentive to enter is reduced or destroyed altogether. For example, where entry requires substantial capital investment which cannot be recovered on exit (i.e. there are sunk costs) entry may be discouraged. In some situations, exit itself may involve further sunk costs, e.g. associated with rendering a site or premises suitable for alternative uses.

Barriers to entry, expansion or exit in retailing gas and electricity in Victoria can take a variety of forms. They could be structural, strategic or be related to the legal and regulatory framework. The issues to be analysed in this section of Chapter 7 are:

- the ease or difficulty of access to and the cost of contracts for energy supply and risk management facilities (**Section 7.1.1**);
- access to network infrastructure (**Section 7.1.2**);
- the presence of economies of scale and scope (**Section 7.1.3**);
- the perceived advantages accruing to legacy retailers (**Section 7.1.4**);
- entry costs associated with customer behaviour, marketing and brand loyalty (**Section 7.1.5**); and
- exit costs (**Section 7.1.6**).

### 7.1.1 Access to wholesale energy supply and risk management tools

The Commission has previously noted that the ability to commence and operate a competitive energy retail business is affected by the extent to which retailers can

access wholesale energy and appropriate risk management tools to manage exposure in those markets, particularly in the case of electricity.<sup>259</sup>

The arrangements for retailers to obtain wholesale energy supply are different for electricity and gas and, as such, the ability to access one fuel does not guarantee access to the other. In recognition of these differences, the Commission has presented its analysis of the arrangements for electricity and gas separately.

#### **7.1.1.1 Electricity**

All wholesale electricity is purchased through the spot market operated by NEMMCO.<sup>260</sup> About 180,000 gigawatt hours of electrical energy with a typical value of \$7 billion is traded each year through the wholesale spot market.<sup>261</sup> Any person who is registered with NEMMCO as a market participant is entitled to buy electricity on the spot market.

NERA, in its report to the Commission, stated that a large number of the generators in Victoria are privately owned. There are five companies that each control over 10 per cent of the total generation capacity in Victoria. Although Victorian retailers can contract with generators outside of Victoria, these five companies represented 24 per cent of total NEM electricity supplied in 2005/06.<sup>262</sup> NERA noted that the privatisation of generation capacity means the total capacity share and proportion of output for any one generator tends to be lower than for generators in states where the majority of generators are government-owned. In addition, NERA considered that the market share of larger generators has been steadily eroded through ongoing investment in alternative energy sources, and anticipated this trend is likely to continue.<sup>263</sup>

The price at which electricity is bought and sold varies on a half hourly basis and can range from -\$999 to a maximum of \$10,000 per MWh. The potential for such extreme variations exposes retailers to two main categories of risk:

- price risk, which results from the volatility of the spot price; and
- financial risk due to volume uncertainty, which arises when the customer load exceeds the retailer's contracted load and the retailer is forced to buy on the spot market at prevailing spot prices.

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<sup>259</sup> Australian Energy Market Commission, *Review of the Effectiveness of Competition in Gas and Electricity Retail Markets – Issues Paper*, 1 June 2007, p. 13.

<sup>260</sup> The National Electricity Market Management Company (NEMMCO) fulfils the dual roles of market operator and system operator for the NEM. This means that NEMMCO is responsible for managing both the wholesale spot market in electricity and the transmission elements of the physical power system that underpins the operation of the NEM.

<sup>261</sup> NEMMCO, *Annual Report 2006*, 2006, p. 4.

<sup>262</sup> NERA Economic Consulting, *The Wholesale Electricity Market in Australia: A Report to the Australian Energy Market Commission*, June 2007, pp. 40, 43.

<sup>263</sup> *Ibid*, p. 95.

As noted in Chapter 4, the central function of an Australian energy retailer is to act as an intermediary between the electricity generator and the end use customer which, because of fluctuations in the wholesale price of electricity compared to committed retail prices, can expose the retailer to price risk. Accordingly, retailers enter into forward contracts and a range of derivative instruments to hedge their exposure. In this sense, retailers provide risk management services to end use customers which enable the retailer to offer longer term supply contracts at specified prices and limit customers' exposure to price fluctuations in the wholesale market. The costs incurred by retailers include the cost and risk of providing these risk management services and must be recovered in retail prices. The Retailer Survey showed a retailer consensus that risk management was the key to success for retailing in Victoria.<sup>264</sup>

The most common strategy to manage risk is to enter into financial contracts with generators to lock in the future price of electricity that will be supplied by a generator or purchased by a retailer.<sup>265</sup> These contracts are known as derivatives and include swaps, options, caps and futures.

The effectiveness of derivatives as a risk management tool is contingent upon a retailer being able to gain access to a financial contract which in turn requires there to be sufficient liquidity in the contracting market. Two recent studies canvassing this issue concluded that there is sufficient liquidity to enable retailers to manage spot price risk. However, KPMG did note that liquidity is not uniform across the NEM and is limited to contract periods of up to three years, certain regions and "vanilla" base-load products.<sup>266</sup>

This conclusion is reflected in the results of the Retailer Survey. As part of the survey, participants were asked about their views regarding the impact of the wholesale market as a barrier to entry and expansion. For electricity, new retailers considered that access to energy and risk mitigation products were more likely to be a major deterrent to entry compared to host retailers. However, there is no evidence to suggest that, to date, new retailers have not been able to access sufficient forward cover to enable them to enter and operate efficiently. As one retailer noted:<sup>267</sup>

"... some of the new entrants have clearly been able to go and negotiate with generators on an arrangement that must look something akin to guaranteeing their retail margin and the generator taking all of the wholesale price risk ... There's been a circumstance in the last few weeks where it's been harder to get contracts from generators, but that feels like it's a moment in time rather than structural."

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<sup>264</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study*, October 2007, p. 51.

<sup>265</sup> NEMMCO, *Australia's National Electricity Market: Trading Arrangements in the NEM*, 2004, p. 25.

<sup>266</sup> PricewaterhouseCoopers, *Independent Survey of Contract Market Liquidity in the National Electricity Market*, 2006, p. 22 and KPMG, *Review of Energy Related Financial Markets*, November 2006, pp. 22-23.

<sup>267</sup> Retailer Survey.

The Commission notes the improvements to the exchange traded electricity contracts introduced in 2002 which has increased total market turnover in electricity derivatives.<sup>268</sup> The alternative sources of risk management products should be enhanced by the options for integration of the spot and forward contract markets being developed as part of the MCE work program<sup>269</sup>, including the Commission's recent Rule change decision to facilitate the netting off of spot and contract positions of market participants.<sup>270</sup>

A second risk management strategy that is becoming increasingly prevalent in Australian energy markets is vertical integration between generation and retail operations. Vertical integration provides the retailer with a natural hedge against price volatility and some protection against contract market illiquidity. Importantly, it may reduce the transaction costs associated with obtaining forward cover and hence promote efficiency in electricity supply.

Retailers' survey responses indicated that vertical integration of retailing and generation was considered to be an important structural feature of retail competition in Victoria. However, the average rating of the importance of vertical integration for a retailer to be competitive differed markedly between new retailers (8 out of 10) compared to host retailers (4 out of 10), which may reflect the fact that host retailers already have affiliations with electricity generators. Host retailers acknowledged that vertical integration can play a role in developing a successful retailer business depending on the scale of the retail operation.

The Consumer Action Law Centre's submission to the Issues Paper expressed concern that vertical integration may create a barrier to new entry and allow host retailers to accrue market power and that vertical integration may also reduce liquidity in the financial contracts market.<sup>271</sup> Reduced liquidity can result where all, or a substantial proportion of, generation capacity is contracted to an associated retailer such that a new retailer is unable to secure hedge cover.

Of the 13 retailers that currently sell electricity to domestic or small business customers in Victoria, six of these (including three new retailers) are affiliated with generators such that they can be considered to be part of a vertically integrated generation and retail business. The Commission canvassed the impact that vertical integration was perceived as having on retail competition through the Retailer Survey. Host retailers considered that any effect was negligible. Notwithstanding their affiliated generation assets, two of the three host retailers are net purchasers of electricity, meaning that their retail load exceeds their generation capacity and they

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<sup>268</sup> PricewaterhouseCoopers, *Independent Survey of Contract Market Liquidity in the National Electricity Market*, 2006, p. 22 and KPMG, *Review of Energy Related Financial Markets*, November 2006, p. 31.

<sup>269</sup> Ministerial Council on Energy, *Ministerial Council on Energy Communiqué*, 25 May 2007, p. 3.

<sup>270</sup> *National Electricity Amendment (Reallocations) Rule 2007 No. 1*.

<sup>271</sup> Consumer Action Law Centre, submission to the Issues Paper, p. 3. However, the submission went on to note that it was not convinced that the diminished competition that resulted from reduced liquidity in financial contract markets caused by vertical integration was outweighed by the efficiency gains.

must contract with third party generators to meet the excess load. While new retailers, including those without generation affiliation, acknowledged the importance of vertical integration to be competitive in retailing electricity in Victoria, they were also of the view that the current level of vertical integration was not impacting on their ability to access energy. Indeed, they considered that as long as there was sufficient independent generation in Victoria access to energy would not be a particular problem.

Those retailers that have more generation capacity than retail load will have excess wholesale electricity which they will seek to sell to other parties in addition to the energy offered by independent generators, either through forward contracts or the spot market.

However, the majority of retail businesses who are affiliated with generation assets – including AGL Energy and Origin Energy – remain net purchasers of wholesale electricity, meaning their generation assets do not have sufficient capacity to meet their entire retail load. Accordingly, these retailers must compete for access to wholesale energy supply and risk mitigation products with those retailers who do not have interests in generation assets. Rivalry between retailers in the financial contracts market is therefore expected to be strong, ensuring a continued high level of demand.

Notwithstanding the importance that new retailers attached to vertical integration, they acknowledged that the current level of vertical integration was not impacting on their ability to access wholesale energy. Indeed, they considered that access to risk management contracts was unlikely to become problematic while ever there was sufficient independent generation in Victoria. However, the Commission notes, and agrees with, the observation by the Energy Reform Implementation Group (ERIG) that there is a need to maintain a “watching brief” in order to monitor developments in this area of market structure. This remains a role for the ACCC.<sup>272</sup>

The Commission is of the view that access to wholesale electricity supply and to risk management products is currently not a significant barrier to competitive entry or expansion in Victoria. As long as independent generation remains, or generation capacity exceeds customer load, the Commission considers that new and expanding retailers will be able to source the required quantities of electricity. Even if access to electricity risk management contracts were to become so difficult that it effectively required retail entrants to enter electricity generation also, if this reflects transaction cost efficiencies and there is sufficient rivalry between vertically integrated retailers, competition can still be effective.

#### **7.1.1.2 Gas**

As noted above, the process by which retailers acquire wholesale gas differs from the process for acquiring wholesale electricity. In Victoria, the two primary methods for

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<sup>272</sup> Energy Reform Implementation Group, *Energy Reform: The way forward for Australia*, January 2007, p. 222.



purchasing wholesale gas are for a retailer to enter into one or more bilateral supply contracts with gas producers, or to purchase gas through VicPool, the wholesale balancing market.<sup>273</sup> The ease or appropriateness of either strategy will vary between retailers.

In 2005, it was estimated that approximately 95% of the retail market was supplied under long term supply contracts.<sup>274</sup> These contracts are often “foundation contracts”, pursuant to which large users (such as retailers or large commercial and industrial customers) contract to purchase large quantities of gas for long periods, typically 10 to 20 years. As NERA notes:<sup>275</sup>

“The wholesale supply of gas in eastern Australia is dominated by long-term, highly customised bilateral gas supply contracts entered into on an infrequent basis with a limited number of end-users. Invariably, these contracts are highly confidential.”

The duration and contracted gas quantities of many foundation contracts and other similar contractual arrangements mean that a small or new retailer may not be able to contract for access to wholesale gas as readily as a larger retailer, nor may such contracts be appropriate. This view is supported by several new retailers, one of whom noted that gas supply contracts were not readily available for small volumes and, in any event, often contained terms and conditions that imposed significant risk on the retailer. For example, the take or pay volumes often impose substantial volumetric risk for a retailer with a small customer base. Similarly, another new retailer described access to small volumes of gas at competitive prices to be “virtually impossible” to obtain.

Notwithstanding the tension between accessing wholesale gas and doing so at competitive prices, recent developments in the gas supply arrangements have enhanced conditions for competitive entry into gas retailing in Victoria. The amendments to the Gascor contracts permitting gas to be purchased from basins other than Gippsland and permitting the Gippsland basin producers to sell into other markets has also improved the outlook for access to gas in Victoria.<sup>276</sup> Gas market liquidity has also improved in recent years as new gas fields commence production (including Geographe/Thylacine in the Otway Basin), competition from coal seam methane (CSM) increases and the availability of distribution infrastructure improves. ERIG noted that, at the very least, alternate sources of supply “raise threats of

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<sup>273</sup> VicPool is often referred to as a “spot market”, however, this term does not accurately reflect its primary function. It is properly referred to as a balancing market because it allows market participants to trade their daily imbalances. However, VicPool is evolving into a more traditional spot market model as large gas users use it to source uncontracted gas supply.

<sup>274</sup> NERA Economic Consulting, *The Gas Supply Chain in Eastern Australia: A report to the Australian Energy Market Commission*, June 2007, p. 23.

<sup>275</sup> *Id.*

<sup>276</sup> Presentation by Mr Nick Heath, Esso Australia, to the South East Australian Upstream Oil & Gas Conference, Melbourne, 24 October 2003.

contestability which itself can be a significant source of competition.”<sup>277</sup> As one host retailer observed:<sup>278</sup>

“There’s a lot more gas wholesalers who are giving access and the gas incumbents have all found ways to support the new entrants at a wholesale level so ... the market has moved on quite a lot since then from both sides”.

The construction of the SEA Gas pipeline, the Eastern Gas Pipeline, the Interconnect and the Tasmanian Gas Pipeline has interconnected south eastern Australia, thereby increasing the supply alternatives available to buyers in these areas<sup>279</sup> and relieving supply constraints into Victoria. However, NERA notes that the commercial viability of alternative sources of supply are constrained by the transportation costs incurred in delivering the gas from the basin to the end user and the capacity available on the relevant pipeline.<sup>280</sup>

VicPool also facilitates entry by small retailers by enabling them to purchase small quantities of gas without the difficulties associated with obtaining contracts on reasonable terms.<sup>281</sup> This benefit was noted by several retailers (albeit, host retailers who have adequate forward contracts), although it was acknowledged that relying on VicPool does leave the retailer exposed to price volatility.

The price risks associated with wholesale gas exist for retailers who have entered into bilateral supply contracts, as well as for those purchasing through VicPool. The contract price payable is typically specified for an initial period and is periodically reviewed. The risk borne by the retailer is that the price will increase above that which the retailer can pass on to its customers. Bilateral contracts can also expose retailers to volume risk, which arises when demand deviates from contracted volumes. While there are risk management tools available to manage these risks, the tools are less sophisticated and less liquid than for electricity.

Some larger retailers have sought to offset their price risk by acquiring an equity interest in the gas field that supplies their gas, or in other gas fields. For example, Origin Energy holds equity interests in the Cooper/Eromanga, Otway and Bass gas basins and the Bowen/Surat CSM basin in Queensland.<sup>282</sup> Similarly, AGL Energy holds interests in CSM basins through joint venture arrangements with each of Sydney Gas Company and Arrow, and through its interest in the Queensland Gas Company.<sup>283</sup> AGL noted that the objectives of its acquisition of upstream

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<sup>277</sup> Energy Reform Implementation Group, *Energy Reform: The way forward for Australia*, January 2007, p. 127.

<sup>278</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 51.

<sup>279</sup> NERA Economic Consulting, *The Gas Supply Chain in Eastern Australia: A Report to the Australian Energy Market Commission*, June 2007, p. 36.

<sup>280</sup> *Ibid*, p. 43.

<sup>281</sup> *Ibid*, p. 29.

<sup>282</sup> *Ibid*, p. 17.

<sup>283</sup> *Ibid*, p. 22.

production interests included improving its ability to manage and mitigate risk and to profit from future price appreciation.<sup>284</sup> While ownership in upstream interests may help to mitigate price risk, it does expose the retailer to a range of other financial risks, notably that expectations about the proven and probable reserves, upon which the acquisition price is based, may not be realised.<sup>285</sup>

Volume risk arises from the potential misalignment between the forecast demand specified by a retailer in its bilateral contract and actual demand, both within a contract year and over the life of the contract. These risks are typically managed through the inclusion of contractual mechanisms (such as swing factors) or through separate contracts for ancillary storage services, including the Western Underground Storage facility and the LNG facility at Dandenong. As previously noted, another strategy for managing excess demand is to purchase gas through VicPool.

Following the publication of the First Draft Report, the Commission was made aware of the impact on gas retailers of recent changes to the manner in which liability for congestion uplift charges is determined under the MSO Rules. Congestion uplift charges are levied on gas market participants by VENCORP to recover the cost of ancillary payments made to market participants who inject gas outside of the normal bid stack to remedy localised gas shortages.<sup>286</sup> Since the amendments to the MSO Rules in February 2007, congestion uplift charges have been calculated using a “causer pays” methodology, meaning that the parties who cause or contribute to the localised gas shortage are liable for the congestion uplift charge.

The impact of the changes to the MSO Rules was the subject of submissions from Victoria Electricity and Simply Energy. Australian Power & Gas provided a confidential submission on this issue. In short, gas retailers face an additional and significant price risk that is separate from the price risk associated with buying gas through VicPool. For example, the market demand and weather conditions experienced during winter 2007 in Victoria, resulted in congestion uplift charges being levied that, on some days, amounted to many millions of dollars. While there are some options available to hedge the risk of incurring substantial congestion uplift charges, these opportunities are limited.

The Commission considers that the ability of retailers to obtain adequate hedges against uplift charges of this quantum needs to be addressed in order to ensure there is no ongoing impediment to entry into and expansion within gas retailing in Victoria. The Commission understands that the implications for hedging arrangements were not clear at the time the amendments to the MSO Rules were made. The Commission further understands that VENCORP is working with market participants through the Gas Market Consultative Committee to develop a suitable solution which will minimise the competitive impact of the scarcity of hedging instruments, and suggests that this matter should be kept under review.

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<sup>284</sup> *Ibid*, pp. 22-23.

<sup>285</sup> *Ibid*, p. 60.

<sup>286</sup> Victoria Electricity, submission to the First Draft Report, p. 1.

Subject to timely and appropriate resolution of the process for managing the risks associated with liability for congestion uplift charges, gas retailers are optimistic about the future of competition. Conditions for retail entry are expected to further improve as substitutability between production sources increases, transmission capacity grows and becomes more transparent and a stronger spot market develops. One host retailer stated:<sup>287</sup>

“I’d be optimistic it’s heading in the right direction and it’s only going to become more transparent and more competitive”.

In light of the views put forward by retailers and the report provided by NERA, the Commission considers that small retailers are able to secure sufficient wholesale gas supplies in order to establish gas retailing operations, but that a focused review of the effect of the availability of hedging arrangements to manage liability for congestion uplift charges is required. Further, the difficulties in obtaining bilateral contracts for wholesale gas that appropriately manage risk may limit opportunities for expansion. These limitations may, in turn, result in fewer constraints on established retailers, however, the Commission does not consider that the more limited flexibility characterising upstream contracting (relative to electricity financial contracts) constitutes a substantial barrier to entry or expansion in the retail sector.

### **7.1.2 Access to network infrastructure**

Access to transmission and distribution networks has the potential to be a barrier to entry where the infrastructure owner restricts or hinders access to relevant network services. The detrimental effects that refusing access to monopoly infrastructure can have on the development of competition has led to the introduction of mandatory access requirements for essential services. Currently, access regimes apply to electricity distribution services, to prescribed electricity transmission services under the National Electricity Rules and to transmission and distribution pipelines declared to be “covered” under the National Third Party Access Code for Natural Gas Pipelines.

Even with access regimes for distribution networks, vertical integration between retailers and distributors can create asymmetries between competitors which may restrict retail rivalry and deter entry. However, no such integration exists in Victoria.

### **7.1.3 Economies of scale and scope**

Economies of scale exist if the long-run average cost of production declines as the rate of output increases.<sup>288</sup> Economies of scope are present where the unit costs of a business producing two related but distinct products is lower for a given output than

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<sup>287</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 51.

<sup>288</sup> Jeffrey Church and Roger Ware, *Industrial Organization: A Strategic Approach*, McGraw Hill, Boston, 2000, p. 54.

if those products were produced by two separate businesses.<sup>289</sup> Economies of scale may deter entry if entry on an efficient scale requires significant sunk costs and/or would be likely to result in post-entry prices that depress expected profits below an acceptable level. In the Statement of Approach, the Commission foreshadowed that it would consider the effect of economies of scale and scope on the effectiveness of competition in energy retailing in Victoria.<sup>290</sup> In this section, the Commission examines the various measures used by energy retailers to realise scale and scope economies and the effect these economies may have for entry, expansion and exit.

Realising economies of scale can result in tangible benefits for both retailers and customers. As one host retailer explained, economies of scale reduce average fixed costs, improve the utilisation of fixed assets and potentially contribute to a higher margin. In a competitive market, a reduction in the average cost is reflected in a lower price to customers. This may enable the retailer to attract more customers, further reducing the average cost and allowing the retailer to become more competitive.

The Retailer Survey asked respondents whether there was a “critical mass” or a minimum scale of operation that a retailer needs to achieve in order to compete effectively in electricity and/or gas retailing in Victoria. The results clearly indicate that critical mass will vary according to the business model adopted by the individual retailer. For example, one new retailer observed that the cost of infrastructure or the outsourcing arrangements put in place would be lower for a retailer whose business model was to grow to 50,000 customers, in contrast to a retailer seeking to compete in the mass market. The same retailer considered that the fixed costs associated with competing in the mass market required a customer base of 100,000. Other new retailers expressed concurring views.

Host retailers typically invest in in-house billing and call centre services and can benefit from economies of scale in recovering these costs across a large customer base. However, a number of new retailers are adopting business models that render these fixed costs “scalable” by outsourcing the performance of the underlying functions to third parties. This enables the retailer to benefit from the scale of the contracted service provider without the need for a large customer base.

Direct sales and marketing functions (such as door-to-door selling and telesales) may also be outsourced to third parties.<sup>291</sup> As discussed in Chapter 5, direct contact strategies such as door-to-door marketing and telesales are the most commonly used and most effective channels for marketing energy products in Victoria. By engaging third parties to perform these functions, the retailer can scale its expenditure on these activities as appropriate. Again, this enables the retailer to receive the benefits of the

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<sup>289</sup> Robert S. Pindyck and Daniel L. Rubinfeld *Microeconomics*, 5<sup>th</sup> ed, Prentice Hall, New Jersey, 1995, p. 231.

<sup>290</sup> Australian Energy Market Commission, *Review of the Effectiveness of Competition in the Gas and Electricity Retail Markets - Statement of Approach*, 19 April 2007, p. 12.

<sup>291</sup> More strategic marketing functions such as the development of marketing strategy, brand management and product design are typically directed and performed by the retailer.

economies of scale realised by the third party service provider while minimising its own expenditure.

The use of outsourcing enables a retailer to increase the scale of the outsourced services at the same (or at a similar) rate as its customer base is growing, thereby avoiding the need to purchase infrastructure or other resources that provide capacity in excess of current demand. One host retailer noted the efficiencies of outsourcing strategies:<sup>292</sup>

“[It] doesn’t mean that necessarily at a small number of customers you can’t have an efficient cost to serve, because you can access those services from third parties on a per activity, per transaction basis.”

The same host retailer noted that the organic growth pursued by many new retailers was advantageous because it enabled them to expand a single system over time. The retailer contrasted this with the experiences of host retailers, whereby the acquisition of legacy businesses can result in diseconomies of scale because the IT and billing infrastructure of each business is unlikely to be compatible with existing systems.

One of the key competitive benefits of implementing business models that rely on outsourcing is that entry by small retailers is viable. By reducing the capital outlay necessary to commence retail operations, scalable fixed costs assist in reducing the sunk costs of entry. This can lower the barriers to exit which, in turn, can further reduce barriers to entry.

The opportunity to offer dual fuel products has provided retailers with the potential to benefit from economies of scope. Dual fuel products lower the average cost to serve by spreading the retailer’s fixed costs over a larger number of customer connections. One retailer observed:<sup>293</sup>

“...it’s a good revenue for virtually the same cost to serve... as a retailer it’s a good revenue because you’ve still got the same back office infrastructure, yet you’ve got virtually double the revenue...”

Another retailer expressed a similar view, noting that the economies of scope that can be realised through dual fuel also facilitate price-based competition:<sup>294</sup>

“Dual fuel makes sense. It’s more margin over the same cost base... You can more heavily discount, you can put retention arrangements in place, it’s a win-win for the retailer and your customer...”

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<sup>292</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, pp. 43-44.

<sup>293</sup> *Ibid*, p. 11.

<sup>294</sup> *Id*.

The Issues Paper sought to test whether consumers of both gas and electricity wanted to be supplied by a single retailer and, if so, whether demand for a dual fuel product creates an obstacle for electricity-only retailers seeking to acquire customers. While submissions did not address this issue in any detail, the results of the Retailer Survey reveal that the competitive advantage afforded by dual fuel is reduced by the scalable nature of many of the retail operating costs. This, in combination with weak customer demand for dual fuel products (discussed in Chapter 6), indicates that electricity-only retailers are unlikely to experience any material disadvantage relative to their dual fuel competitors. Indeed, some smaller retailers (e.g. Victoria Electricity and Red Energy<sup>295</sup>) commenced their energy retailing operations in Victoria first as an electricity-only retailer and only added gas to their retail offer once an electricity business was established.

The Commission considers that developments in technology and outsourcing that enable new retailers to adopt more flexible business models has substantially reduced the cost of entry and the size of the customer base necessary to compete effectively with larger retailers. While economies of scale remain important to sustainable growth and will continue to drive competition, the Commission does not consider that economies of scale and scope currently operate to deter entry or restrict competition.

#### **7.1.4 Host retailer advantages**

A business that operates in an industry prior to the introduction of competition is likely to possess a range of competitive advantages relative to businesses who enter after liberalisation. The apparent competitive advantage that these factors confer, or are perceived as conferring, upon host retailers may deter entry by potential new retailers. In the course of conducting its analysis in preparation for the First Draft Report, the Commission sought to understand whether host retailers possess a competitive advantage relative to new retailers. The key areas of focus were brand recognition and brand loyalty, and any barriers to entry or expansion that may arise because host retailers have an established customer base at the commencement of FRC.

It is reasonable to expect that, at the commencement of FRC, host retailers will have a recognisable brand and that at least some of the customer base will be loyal to that brand. Where brand recognition and loyalty is strong, new retailers will be forced to spend significant time and resources promoting their business in order to overcome the reluctance of customers to switch from an established, known retailer. Where significant expenditure is required, a new retailer may face higher customer acquisition costs than a host retailer, thereby making competitive entry more difficult.

The Commission's analysis of the evidence on brand recognition and loyalty and its effects on competition is set out in detail in Chapter 6. Its conclusions are that

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<sup>295</sup> It is noted that Red Energy, during the preparation of the First Draft Report, commenced offering electricity and gas services but, for present purposes, is treated as an electricity-only retailer.

Victorian energy customers display limited brand recognition. The Consumer Survey results reveal that just over one third of customers could not identify an alternate electricity retailer from their current supplier and approximately half the customers surveyed could not name an alternate gas retailer. The results of the Retailer Survey reflected the limited levels of customer brand recognition, with new retailers giving low ratings of customer awareness of their own retail brand (average of 4/10) but host retailers rating awareness of their brands more highly (average of 8/10).

However, better brand recognition does not necessarily translate into stronger brand loyalty in favour of host retailers and a material barrier to entry. New retailers said that a lack of awareness of their brand did not hinder their ability to acquire customers and the Consumer Survey shows that customers are not motivated to switch by retail brand alone. As discussed in Chapter 6, the absence of customer loyalty to a particular brand means that many customers are willing to switch when directly approached, i.e. through door-to-door marketing or telesales.

As discussed in Chapters 5 and 6, consumer reluctance to engage in search activities and status quo bias<sup>296</sup> can operate in favour of a host retailer because some customers will prefer to remain with their default supplier. The propensity for these customers to remain with the host retailer may impede competition if it deters entry and rivalry for those customers and/or if the host retailer can effectively discriminate against them.

However, an inherited customer base in a competitive environment may also disadvantage a host retailer. Although the host retailer possesses a substantial customer base at the commencement of FRC, as Victoria has demonstrated, switching rates will increase as new retailers grow their shares of customer connections over time. By virtue of their obligation to offer to supply, there is the potential for host retailers to be left with the burden of serving customers that are commercially less attractive to new retailers, for example, by reason of the customer's load profile, demographics, location or credit risk profile. Similarly, host retailers currently bear the obligation to act as the RoLR.

The Commission considers that host retailers are not afforded any clear competitive advantage by virtue of their position as host retailers in an effectively competitive market. While host retailers may be in an advantageous position compared to new entrant retailers at the commencement of FRC, the Commission considers that these benefits dissipate as effective competition develops. Accordingly, the Commission does not consider that the existence of host retailers is creating any substantial barriers to entry to or expansion with in energy retailing in Victoria.

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<sup>296</sup> See, for example, C. Camerer, S. Issacharoff, G. Lowenstein, T. O'Donoghue, and M. Rabin, "Regulation for Conservatives: Behavioural Economics and the Case for 'Asymmetric Paternalism'", *University of Pennsylvania Law Review*, 2003, Vol. 151 No. 121, p. 1,224. The authors cite W. Samuelson and R. Zeckhauser, "Status Quo Bias in Decision Making", *Journal of Risk and Uncertainty*, 1988, Vol. 7.



### **7.1.5 Marketing costs**

As discussed in previous chapters, energy is a homogenous service which is treated by a large proportion of retail energy consumers as a low involvement commodity. Customers may undertake limited search activity on their own behalf and may also exhibit status quo bias. However, as indicated in Chapter 6 and in the previous section of this chapter, customers exhibit limited brand loyalty and do not indicate significant concerns regarding switching costs. When approached by retailers offering attractive prices through direct marketing, many customers are therefore willing to switch retailers.

By providing information directly to customers, retailers can differentiate their service offerings from those of their rivals, while at the same time economising on the search and transaction costs of customers which may otherwise discourage many from exercising choice.

These features of energy retailing have significant implications for entry conditions. For instance, it can be a substantial deterrent to entry if entry requires considerable sunk costs to be invested in mass market advertising, e.g. through television and print media advertisements, in an attempt to overcome entrenched brand loyalty but with no guarantee of success. However, energy retail brand loyalty is weak and these forms of advertising are not regarded as important or effective by retailers. Instead, as discussed in Chapter 5, the nature of customer demand encourages retailers to primarily engage in direct marketing through door-to-door sales and telemarketing. These types of marketing activity are inherently more scalable than mass market advertising, and particularly so when they can be contracted out. Furthermore, the willingness of customers to switch when presented directly with an attractive offer means that retailers can be more confident of achieving some success by employing them.

### **7.1.6 Exit costs**

At the commencement of this chapter, the Commission noted that barriers to exit may exist where entry requires substantial capital investment which cannot be recovered on exit (i.e. there are sunk costs) and, in some cases, exit itself may involve further sunk costs.

Through the Issues Paper and the Retailer Survey, the Commission sought stakeholders' views on the existence, and effect, of exit costs on competition in energy retailing. Neither the submissions to the Issues Paper nor the observations made by retailers during the survey process addressed this matter in any detail. While the Commission notes that there are some costs associated with exiting from energy retailing, such as the costs of remediating the retailer's premises, it does not consider that exit costs constitute a material barrier to competition.

## **7.2 Legislative and regulatory obligations**

The regulatory obligations governing energy retailing have an important influence on the way competition develops. Where it is prescriptive or the compliance costs

are high, regulation can operate as a barrier to entry or expansion. The purpose of this section is to set out the results of the Commission's analysis of the regulatory obligations that are relevant to the Victorian Review. The regulatory obligations are summarised in Chapter 4.

The Commission's analysis in this section is divided into three parts, examining:

- the effects of retail price regulation on the willingness or ability of new retailers to enter or expand (**Section 7.2.1**);
- the effect of the obligation to hold a licence and the costs and obligations incurred in complying with licence conditions (including costs associated with regulatory (in)consistency between jurisdictions) on the ability for new retailers to enter or expand of energy retailing (**Section 7.2.2**); and
- the capacity of retailers to comply with the prudential requirements of wholesale market participation and credit support arrangements required by distribution system agreements (**Section 7.2.3**).

### **7.2.1 Retail price regulation**

The price at which a good or service is bought and sold provides important signals to the market. Pricing indicators enable resources to be allocated in the most efficient manner, and signal demand for investment. If these pricing signals are distorted, for example, through retail price regulation, the market (or parts of the market) may appear unattractive to potential entrants or to existing participants considering expansion.

As explained in Chapter 4, the maximum prices that a host retailer may charge a customer on a standing offer contract is set in accordance with a retail price path negotiated between the Victorian Government and the host electricity and gas retailers. The prices at which market offers are made available are unregulated. The potentially adverse effect that the standing offer price may have on entry into energy retailing is that it may distort the pricing signals, deterring potential entrants or making it appear unattractive for potential or existing retailers to serve some customers at a price at or below the standing offer price. Accordingly, the Commission has sought to understand the effect of the standing offer tariff on the attractiveness of entry into or expansion within energy retailing.

The standing offer tariff has been in place since the introduction of FRC and the ten new electricity and four new gas retailers that are currently operating all commenced operations in Victoria in this environment. Reviews of the standing offers have allowed some tariff re-balancing and the recent applications from Dodo Power & Gas to retail electricity and gas in Victoria indicate that at least some potential entrants consider there is the opportunity for efficient entry based on current market conditions.

However, some retailers hold unfavourable views about the effect of the standing offer tariff on the opportunity for entry. One new retailer considered that removing retail price regulation would "open up the market" and "increase the number of

participants willing to enter.” Similarly, Origin Energy’s submission to the Issues Paper stated:<sup>297</sup>

“The presence of price regulation affects retailers’ choices regarding market entry and innovation, specifically creating a problem with the right of reversion to the standing offer tariff”.

Retailers were also of the view that the standing offer price can make expanding an energy retailing business unattractive. The Retailer Survey asked whether the standing offer limited retailers’ ability to offer prices that reflect the efficient cost to serve. Being able to charge cost-reflective prices is particularly important when considering the cost to serve of low volume or remote customers. On average, host retailers considered the standing offer price to be quite limiting in both gas and electricity (8 out of 10, where 10 is extremely limiting). The average rating given by new electricity retailers was comparable (7 out of 10) but lower for gas (4 out of 10). These results suggest that, at present, the standing offer price (particularly in the case of electricity) may reduce the willingness of existing retailers to expand their retail operations. If corresponding views are held by potential entrants, the perceived difficulties for expansion created by the standing offer price may also be reducing the attractiveness of retail entry.

As noted in Chapters 5 and 6, some stakeholders consider that the existence of a standing offer tariff facilitates price-based competition. Although the Commission notes that this may be one possible effect, there is no necessary relationship between the standing offer tariff and a competitive price and, as more customers move onto market contracts, it becomes increasingly inappropriate as a benchmark. Further, price transparency can also facilitate price coordination around the focal point provided by the regulated published tariff and discourage discounting.<sup>298</sup> In addition, where the tariff is set at a level that does not permit retailers to charge cost-reflective prices, there is no incentive for retailers to market their offers at all. Simply Energy admits to being in this position earlier this year:<sup>299</sup>

“Simply Energy suspended active marketing of its energy products from 1 July this year, although it maintained a single fixed-rate offer which was available to residential customers during the period of suspension. The reason for suspending marketing activities was that increases in the wholesale cost of electricity meant that market offers priced at a discount to the standing offer were unprofitable...

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<sup>297</sup> Origin Energy, Submission to the Issues Paper, p. 9.

<sup>298</sup> See, for example, David Genesove and Wallace P Mullin, “Rules, Communication and Collusion: Narrative Evidence from the Sugar Institute Case”, *The American Economic Review*, Vol. 91 No. 3, June 2001, 379; Svend Albaek, Peter Mollgaard and Per B Overgaard, “Government Assisted Oligopoly Coordination? A Concrete Case”, *The Journal of Industrial Economics*, Vol. XLV, No. 4, December 1997, 429; and Jill Walker and Luke Woodward, “The Ampol/Caltex Australia Merger: Trade Practices Issues”, *Trade Practices Law Journal*, Vol. 4, No. 1, March 1996, 21.

<sup>299</sup> Simply Energy, submission to the First Draft Report, p. 1.

Had it not been for price regulation, Simply Energy may have continued to participate actively in the market during this period at market offer prices that reflect the underlying cost of energy. The presence of standing offer prices meant that this was not viable.”

Although the Commission accepts that the standing offer tariff does not preclude retailers from charging a higher price<sup>300</sup>, to the extent that the tariff acts as the focal point for price-based competition, as a matter of practice, market offer tariffs need to be lower.

The Commission notes the views put forward by retailers on the limitations imposed by the standing offer tariff. An important determinant of the effect that retail price regulation has on the attractiveness of entry into or expansion within energy retailing in Victoria is the ability for host retailers to rebalance the standing offer tariffs to reflect variations in the cost to serve. The Commission does not have before it any evidence of any obstacles that retailers face in undertaking tariff rebalancing. Indeed, Origin Energy noted:<sup>301</sup>

“the Victorian price regulation model has allowed restructuring such that margins (% return on sales) are relatively stable across customer segments despite variations in consumption patterns.”

The Commission’s analysis of these issues is set out in further detail in Chapter 8.

## **7.2.2 Regulatory compliance and consistency**

Victorian retail energy businesses must comply with a range of regulatory obligations, some of which were summarised in Chapter 4. Some of these obligations are prescribed by legislation or regulations, others are contained in licence conditions or in other regulatory instruments (such as codes and guidelines) which apply by virtue of a licence condition. Where the regulatory costs facing established retailers differ from those facing potential entrants, this may create a barrier to entry. The focus of this section is whether the scope and compliance costs of the regulatory obligations that apply in Victoria affect the willingness of potential entrants to enter or impact adversely on the capacity of existing retailers to compete. Noting the frequency with which it was discussed during the consultation process, the following section gives particular focus to the current obligations for managing customers experiencing financial hardship.

One of the most prominent regulatory obligations for Victorian retailers is to ensure they hold the appropriate retail licence. Notwithstanding the annual licence fees payable (which are set out in Chapter 4), retailers made little comment about this obligation. The nature of the licensing costs does not appear to create a significant asymmetry between established retailers and potential entrants. The Commission

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<sup>300</sup> Victorian Council of Social Service, submission to the First Draft Report, p. 3.

<sup>301</sup> Origin Energy, submission to the Issues Paper, p. 3.

notes that retailers generally acknowledge and accept the policy requirement to hold a licence. Origin Energy, in its submission to the ESC in response to Dodo Power & Gas' applications for retail licences, noted the importance of the application process in protecting the integrity of energy retailing in Victoria:<sup>302</sup>

"Origin therefore encourages the Commission to ensure that all new entrants to the market, whatever their size or business model, have the operational capabilities, compliance systems and customer support mechanisms to support these standards."

Noting Origin Energy's view, the Commission considers that licensing obligations and a rigorous application process give customers and other parties who are required to trade with the retailer confidence that the new retailer, having satisfied the regulator of its technical and financial capability, is a viable business. Where consumers have confidence in the licensing regime, they are more likely to be willing to switch to new entrants and less likely to depend on established brands as an indicator of reliability. All these matters are important parts of ensuring a secure, efficient energy market.

As noted above, retailers are subject to a licence condition to comply with all applicable codes and guidelines. Given the focus of the Victorian Review, the relevant instruments captured by this condition include the Energy Retail Code, the Marketing Code, and the guidelines on energy product disclosure and financial hardship policies.<sup>303</sup> Collectively, these instruments regulate matters including the terms and conditions (including price) on which retail energy products are offered, the way in which information about products and services is communicated to prospective customers, and minimum standards governing the way retailers may deal with customers.

Some retailers, either through their submissions to the Issues Paper<sup>304</sup> and/or their responses to the Retailer Survey, expressed the view that the regulatory burden (and associated costs of meeting those obligations) was increasing. In its written survey response, one host retailer noted:

"The costs and efficiency of a retailer's business are significantly influenced by the regulatory framework... Further, in [this retailer's] view, the Victorian arrangements impose additional cost and complexity than those imposed in other jurisdictions. This complexity in turn diminishes the benefits that would otherwise flow from energy market reform."

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<sup>302</sup> Letter from Ms Bev Hughson, National Pricing and Tariffs Manager, Origin Energy dated 24 August 2007 to Ms Fiona McKenzie, Licensing Officer, Essential Services Commission, p. 1.

<sup>303</sup> See *Guideline No. 19: Energy Industry – Energy Product Disclosure – Electricity and Gas*, and *Guideline No. 21: Energy Industry – Energy Retailers' Financial Hardship Policies*. The obligations contained in the Codes and the Product Disclosure Guideline are summarised in Appendix D of the First Final Report. The content of the Financial Hardship Guideline is incorporated into the discussion on hardship policies in Chapter 4.

<sup>304</sup> TRUenergy, submission to the Issues Paper, pp. 5-7.

In response to the Issues Paper, the Consumer Action Law Centre noted that the development costs imposed by regulation and business to business systems and processes do not constitute a barrier to entry because they apply to all retailers.<sup>305</sup> Similarly, the Consumer Action Law Centre and the Consumer Utilities Advocacy Centre noted that the Victorian regulatory framework is not a barrier to effective competition.<sup>306</sup>

Retailers also submitted that the regulatory burden is greater (and therefore compliance costs are higher) if retail operations span multiple jurisdictions because of inter-jurisdictional disparities in regulation. Some retailers indicated they were suspending or terminating their plans to enter into other jurisdictions because of the cost of compliance with such disparate regulatory obligations.

The Commission has considered the information before it and considers that, on balance, there is no direct evidence that the costs of regulatory compliance for Victorian and multi-jurisdictional retailers are deterring potential entrants. The Commission notes the information provided by retailers concerning the compliance costs and complexities associated with multi-jurisdiction retailing operations, however, it considers this issue is most appropriately resolved through the MCE energy market reform process and the ongoing work of the Retail Policy Working Group.<sup>307</sup>

#### **7.2.2.1 Managing customers experiencing financial hardship**

A particular issue raised by retailers with possible implications for viable entry and competition is the regulation of their dealings with customers experiencing financial hardship. The policy background to the introduction of these requirements and retailers' obligations in discharging them is summarised in Chapter 4.

Submissions to the Issues Paper from consumer groups supported the Government's commitment to developing solutions to manage the needs of customers who, as a consequence of their personal circumstances (e.g. income insufficiency), experience difficulties in meeting the costs of their energy consumption.<sup>308</sup> Submissions from retailers and the ERAA acknowledged the importance of having appropriate processes in place to assist such customers.<sup>309</sup>

However, retailers questioned the scope and cost implications of the role they are required to play in delivering these programs. For example, retailers queried the

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<sup>305</sup> Consumer Action Law Centre, submission to the Issues Paper, p. 5.

<sup>306</sup> Consumer Action Law Centre, submission to the First Draft Report, p. 9; Consumer Utilities Advocacy Centre, submission to the First Draft Report, p. 5.

<sup>307</sup> This position was supported by the Consumer Utilities Advocacy Centre: see submission to the First Draft Report, p. 5.

<sup>308</sup> See, for example, Consumer Action Law Centre, submission to the Issues Paper, p. 21; Consumer Utilities Advocacy Centre, Submission to the Issues Paper, p. 16.

<sup>309</sup> Energy Retailers Association of Australia, submission to the Issues Paper, p. 3; TRUenergy, Submission to the Issues Paper, p. 8.

appropriateness of the obligation for retailers to provide “flexible options for the purchase or supply of replacement electrical equipment designed for domestic use”. This may be a significantly greater burden for small entrant retailers than for established retailers. While in agreement with the policy objective, retailers suggested that other arrangements or other delivery mechanisms, such as through Government agencies and departments or appropriately funded and experienced non-governmental bodies, may be more appropriate and more effective.<sup>310</sup>

The Commission notes the views of consumer groups who, in their submissions to the First Draft Report, queried the extent to which hardship programs constitute a barrier to effective competition.<sup>311</sup>

The Commission recognises the legitimate and important public policy rationale for providing assistance to customers experiencing financial difficulty in meeting their energy bills and that the hardship policies implemented by retailers are providing important support for these customers. In light of the Commission’s findings that competition is effective, it must now provide advice on ways to phase out retail price regulation, together with appropriate transition arrangements. An important aspect of such arrangements will be options to preserve and, if possible, improve, the support for vulnerable customers that has been achieved through this program. In that context, further consideration can be given to the concerns raised by retailers regarding the breadth, cost and implications for entry and competition of the obligations they are required to discharge under these arrangements. It will be important to ensure that any future mechanisms designed to achieve or further such policy objectives are implemented in the most efficient and balanced manner to achieve the policy objectives while minimising the adverse impact on the effectiveness of competition.

### **7.2.3 Prudential requirements and credit support arrangements**

As noted in Chapter 4, retailers are required to satisfy the prudential requirements administered by the market operators and to provide credit support to distribution network owners. This section considers whether compliance with these requirements limits new entry or restricts existing retailers from expanding.

Retailers expressed concern about the framework for providing both prudential and distribution security. The primary apprehension centres on the lack of flexibility for retailers to negotiate and implement alternate arrangements to satisfy the credit support requirements.

The Retailer Survey results reveal that host retailers consider credit support requirements in both electricity and gas to be a necessary feature of energy retailing. Host retailers recognised that smaller retailers may have concerns about the

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<sup>310</sup> Energy Retailers Association of Australia, submission to the Issues Paper, p. 3; Energy Supply Association of Australia, submission to the First Draft Report, pp. 3-4; Retailer Survey interviews.

<sup>311</sup> Consumer Action Law Centre, submission to the First Draft Report, p. 9; Consumer Utilities Advocacy Centre, submission to the First Draft Report, p. 5.

prudential requirements but considered that it was a scalable cost and that it applied equally amongst all retailers. As one host retailer stated:<sup>312</sup>

“...but whatever the NEMMCO prudential cost to those guys, you can imagine, as you get bigger it gets bigger, it’s not, it doesn’t change in proportions...”

However, new retailers considered it was a negative feature of the regulatory framework. For example, one new retailer stated:<sup>313</sup>

“Prudential standards or prudential requirements are a considerable barrier to entry for small new entrant energy retailers, a more flexible arrangement that allows for a greater use of insurance arrangements will help remove this barrier.”

One means of reducing the cost of the credit support required by the market operator is to take advantage of the NEM reallocations arrangements which permit market participants to net off their spot and contract positions, thereby reducing their net market exposure to NEMMCO. However, the responses of retailers to the Retailer Survey suggests that these arrangements are not widely used in the market. One new retailer advised that unless the retailer has a sufficient credit rating, it is difficult for generators to enter into a reallocations agreement. Another new retailer stated:<sup>314</sup>

“The other key factor with that sort of thing is the prudential security requirements that a new entrant is required to put up to be able to facilitate their entry in to the marketplace ... [one of the] drawbacks of being an new entrant is that you can’t rely on things like credit ratings etc because potentially you don’t have them yet. So what you’re then stuck with as well you’ve got to basically put up dollars to underpin your prudential security requirements.”

With respect to the credit support arrangements required by distributors, retailers noted that the inflexibility associated with these requirements increased the difficulty of commencing an energy retail business in Victoria. For example, one new retailer stated:<sup>315</sup>

“There are some distributors that will allow you to put up an insurance type bond which is better, but again there’s inconsistency ... some will, some won’t... So that’s one of the big hurdles because you’ve got to outlay some of

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<sup>312</sup> Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Retailer Study Research Report*, October 2007, p. 38.

<sup>313</sup> *Id.*

<sup>314</sup> Retailer Survey.

<sup>315</sup> Retailer Survey.



your potential working capital etcetera to offset, put that away so that you can enter in those sorts of agreements and arrangements.”

The impact of distribution credit support arrangements on working capital requirements was also observed by other new retailers, however, they did acknowledge that some positive changes had occurred in Victoria.

The Commission notes the implications for retailers of requirements to commit a proportion of their working capital to meet bank guarantees and credit support arrangements. However, in light of the costs being scalable, the Commission has not been persuaded that these obligations are of such a magnitude that they are a material impediment to entry or expansion. Furthermore, as with the licensing conditions, prudential requirements may contribute to consumer confidence in the market and their willingness to switch to new retailers. Nevertheless, the Commission considers that any initiatives to improve the flexibility of prudential requirements to better meet the needs of wholesale providers and retailers, while continuing to safeguard the financial integrity of the energy markets, would be a positive development.

### **7.3 Commission’s findings**

The conditions for energy retailing in Victoria provide opportunities for efficient retailers to enter the market. There is sufficient access to wholesale energy supply and related risk management instruments to enable new entrants to compete, although the liquidity of markets for risk management instruments is greater for electricity products than for gas.

Conditions are similarly positive for the expansion of retail businesses. The Commission notes the limitations on the flexibility associated with entering into bilateral gas supply contracts but considers that there are strong signals that competition for wholesale supply will continue to increase.

Developments in technology and contracting have reduced the need to attain a significant “critical mass” for profitable entry. New retailers are adopting business models that embody more flexible approaches to managing costs that enable them to more easily realise the benefits of economies of scale, for example, through contracting out retailing services to specialist third party providers.

The Commission notes the concerns raised about the potential effects of vertical integration on competition. However, based on its analysis, the Commission concludes that vertical integration is not presently having a detrimental effect on conditions for entry or expansion but should be monitored going forward. Furthermore, it is likely that vertical integration involves transaction cost efficiencies which will ultimately benefit consumers provided there is sufficient competition between vertically integrated retailers.

While host retailers may have inherited a significant customer base, the low levels of brand loyalty and customers’ demonstrated willingness to switch retailers when approached with an attractive offer has resulted in new and established retailers engaging in direct marketing and sales activities. Direct marketing costs are

relatively scalable and retailers are confident they can expect a reasonable degree of success.

The Commission further notes the absence of any significant barriers to exit.

The regulatory obligations that apply to energy retailers are, in large part, shared by all retailers. However, it has a demonstrable effect on the perceptions of potential entrants on the ability to commence efficient retail operations. While the range of regulatory obligations evidently has some impact on retailer cost structures and would be a consideration for businesses contemplating retailing energy in Victoria, the Commission considers that this effect is not of such a magnitude that it is deterring either new entry or expansion. Furthermore, some level of licensing and prudential regulation may be important for ensuring consumer confidence and willingness to participate in the competitive market.

On balance, the Commission's conclusion is that the current conditions for entry, expansion and exit are facilitating new entry, thereby constraining retailers in their price setting and output decisions. The fact that new retailers have entered, continue to enter and are expanding their retail businesses is indicative of the absence of significant entry barriers and reinforces the credibility of the threat of contestable entry.

## 8 Measured Profit Margins

The purpose of this chapter is to consider the extent to which the profit margins earned by retailers on their market offers are reflective of outcomes that would be expected in a competitive environment. However, retailers will only seek to make competitive market offers to customers where it is profitable to do so. Therefore, this chapter will also consider if the standing offer tariff is allowing retailers to profitably enter the market and make competitive offers to all customers.

In markets that are characterised by effective competition, there is pressure for prices to trend towards efficient cost over time. The process of customers choosing the best offer amongst alternative suppliers provides competitive pressure for all suppliers to match and improve upon the price and non-price offers of their rivals in order to maintain market share. The ability of customers to exercise choice also provides the opportunity and incentive for new retailers to enter the market, until further reductions in price or improvements in the quality of the good become unprofitable. At this point all efficient economic costs, but no more, are being recovered.<sup>316</sup> If prices fall below the level where efficient firms are able to recover their economic costs, some businesses will be forced to exit the market. This will continue until prices rise sufficiently for economic costs to be recovered.

By contrast, in a market where firms are able to exercise substantial market power, businesses are able to maintain price significantly above economic cost and profit motivated firms have the incentive to take advantage of that capability.<sup>317</sup> In that case, the revenue that firms earn may exceed economic cost by a significant margin, and the gap between revenue and cost can be sustained.

It follows that one indicator of whether competition is effective in Victorian energy retailing is whether the margin retailers earn between revenue and economic cost is consistent with or in excess of a competitive return commensurate with the risks involved.

A convenient means of measuring the extent to which retailers' revenues align with their economic costs is to measure retailers' profitability. Measures of profitability are simply the residual that remains after certain categories of cost have been recovered. Measured profit can then be compared to the level that would be expected to occur in a competitive market. That is, the residual that can be explained by economic cost (i.e. financing costs, risk borne, etc), which is referred to in the discussion below as a competitive margin. The Commission has used the standard measure of profit that is applied for retail businesses; namely, profit measured as earnings before interest and taxation (EBIT) expressed as a percentage of sales

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<sup>316</sup> The term "economic costs" refers to all costs that are recognised in economics as necessary to incur in supplying a good or service, including a return on investments made and compensation for risks borne.

<sup>317</sup> For substantial market power to exist, customers need to have limited or no alternatives to their current supplier (including for there to be barriers that dissuade new suppliers from entering and/or customers from switching) so that the process of customers 'voting with their feet' and hence disciplining the terms offered by suppliers is muted or absent.

revenue. This measure of profitability is referred to as the profit margin in the discussion below.

There are several caveats that need to be borne in mind when interpreting the estimates of margins that are reported herein and drawing inferences about the effectiveness of competition.

First, as discussed above, the expectation is that the process of competition will lead to prices converging to economic costs (and the margin converging to the competitive level) over time. However, the margin that is observed at any point in time may be materially higher or lower than the competitive level as the market responds to changes (for example, a step change in costs) or to other new information and as entry and exit of new retailers occurs.

In addition, retailers offer prices that are fixed for a period of time, based upon their forecasts about future costs (as discussed below, retailers inevitably bear an exposure to the spot market). Thus, even if the prices that retailers offer included a competitive margin over the *forecast* cost of serving that customer, the observed margin – which will reflect the *actual* costs that retailers incur – inevitably will differ to the intended margin merely as a result of the difference between forecast and actual costs.

The implication of the two points above is that it is difficult to draw strong inferences about the extent of competition from the margins that are observed at any point in time. Rather, the appropriate focus is upon the trend in margins over a number of years.

Secondly, even though variable costs<sup>318</sup> make up a higher proportion of a retailer's cost structure than they do, for example, for a network business, some retail costs are incurred jointly across customer segments. Retailers would need to recover all of their costs to remain in business over time, including costs that are incurred jointly across customers and customer groups. However, there is no reason to expect that all customers and customer groups would be charged the same pro-rated share of these costs. Rather it would be expected that retailers would seek to recover joint costs by applying a different mark-up over marginal cost depending on the price sensitivity of demand by the relevant customer segment (often referred to as Ramsey pricing). A result of this efficient recovery of joint costs is that, while a competitive margin would be expected across all customers, a higher or lower margin would be expected across particular customer segments.

Thirdly, the assessment of the retailers' margins is subject to a potentially material measurement error. The Commission does not have a formal power to gather revenue and cost information from the retailers. Instead it has relied upon imperfect proxies for revenue (or average prices) and costs, which potentially are subject to significant measurement error. While the Consumer Action Law Centre had the view that retailers should be required to provide more information about the extent

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<sup>318</sup> Variable costs are costs that vary with the number of customers served or with the amount of energy consumed.

of their profit margins<sup>319</sup>, the lack of formal power means the Commission must rely on the voluntary disclosure of information by retailers and publicly available information sources. Moreover, even if information on actual costs and revenue were available, measurement error of actual costs remains.<sup>320</sup> In addition, the relevant question is whether the measured margin is consistent with the margin that would be earned by an *efficient* retailer; that is, one that effectively managed its input costs, price structures and its risk exposures. A further matter to be addressed, therefore, is whether that efficiency standard has been met.

Fourthly, the standard against which margins should be benchmarked – the competitive margin – is also subject to significant measurement error. The level of imprecision in the analysis discussed above means that it may be difficult to draw a strong inference from the computed margins (based on imperfect cost and revenue data) regarding the degree of competition in the market.

Indeed, the difficulty that is involved in attempting to estimate efficient cost and the efficient price level is one of the reasons for preferring competition over regulation where the former is feasible. In competitive markets, no single entity is required to estimate efficient cost. Rather, efficient cost and the efficient price level are revealed over time by the process of offer and counter offer and entry and exit from the market.

Lastly, it follows from the discussion above that the margins that are of most relevance to the assessment of competition in Victorian energy retailing are the margins made when energy is sold to customers under market contracts, as this provides an insight into where the ‘market’ has settled. However, it is also relevant to examine the margins that are able to be earned under the prevailing standing offer tariffs.

In particular, if the margin that is earned under these tariffs is found to be low – either generally or for specific locations or customer types – then an implication may be that the existence of the standing offer tariff is impeding entry or foreclosing competition to those regions or customers types. This information is relevant to considering the nature of any impediment to competition and assessing the costs of continuing to regulate.

In considering these issues the following topics are discussed:

- the costs that comprise the retail costs of gas and electricity and how these impact on price decisions and profit margins;

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<sup>319</sup> Consumer Action Law Centre, submission to the First Draft Report, p. 10.

<sup>320</sup> For example, the presence of costs that are incurred jointly with other customer groups or in common across other activities means there is no single, correct cost observation of cost for retailing to this group of customers. In addition, the combination of extreme volatility in spot prices, material volatility in the prices of derivatives instruments and volatility in customer consumption imply material bounds of error in estimates of the wholesale electricity purchase cost incurred to supply a customer.

- the margins that are available under the standing offer tariff and market offer tariffs generally; and
- the margins that are available for specific regions and customer types.

## 8.1 Measuring average retail costs, revenues and margins

### 8.1.1 Character of retail costs and revenues

The economic costs that are incurred by retailers to supply energy to end-users are as follows:

- **Energy Costs** – These are the costs associated with purchasing wholesale electricity and gas for end-use customers. The size of these costs and the manner in which they are managed are different between electricity and gas. However, in each instance factors other than the basic cost of energy need to be considered, such as the risks faced in purchasing energy, the costs of mitigating risks and network losses. In addition, the costs of participating in the market for energy (such as market participant fees) fall into this category, as well as the cost of meeting legislative obligations with respect to energy purchases (such as purchasing the required amount of renewable energy under the MRET scheme).
- **Transmission and distribution network charges** – These are the costs incurred by retailers for the transportation of energy from the point of production to the site of the relevant customer. As these functions are monopoly-like, the prices for transportation are regulated in Victoria by either the AER or the ESC. Accordingly, retailers are not able to manage the size of these costs.
- **Retail operating costs** – These are the costs associated with providing the services of energy retailing. They typically include billing and revenue collection, call centres, financing costs, IT systems, fulfilling regulatory obligations and overheads and indirect costs. Retailers either provide these services internally or outsource them to third parties.
- **Customer acquisition costs** – These are the costs that retailers incur to attract new customers and to retain their existing customers. Unlike other costs, the amount a retailer spends on customer acquisition is at its own discretion. However, without retailers attempting to draw customers from rivals – and hence incurring acquisition costs – it is unlikely that competition would be effective.
- **Retail margin** – This is the additional revenue that retailers earn over the costs described above through supplying energy to customers. The role of the retail margin is to compensate retailers for the cost of financing the stock of capital required to provide retail services (such as IT costs), to compensate for the working capital required, and to compensate retailers for the risk incurred in retailing. Firms require compensation for these financing costs and risks in order to remain commercially viable (and hence to remain in operation) over the long term.

The logical starting point for estimating the margins that currently are being earned by retailers in the Victorian market would be to obtain information on the actual costs incurred and revenues received from this activity. However, information on actual costs and revenues has not been available to the Commission. The analysis of margins has instead been based upon estimates of the efficient cost of serving customers in Victoria and plausible assumptions about average revenue levels, based upon knowledge of the market offers in existence.<sup>321</sup>

As noted above, the use of benchmark assumptions for the costs of the retailers creates an additional degree of imprecision in the results of the exercise, particularly for the wholesale energy purchase cost. As discussed in Chapter 4, the essential function of an energy retailer is to act as an intermediary between final consumers and the wholesale market and to manage the associated price and volume risk on their behalf. The efficiency of risk management is one of the key areas where a retailer may obtain a competitive advantage over others, given that different portfolios of contracts and purchasing strategies can have a material effect on the retailer's average cost of energy and risk exposure,<sup>322</sup> as noted by Origin Energy.<sup>323</sup>

“...it needs to be recognised that a retailer's task is to manage risk and market products to end customers. The efficient long run costs of supply only apply to the regulatory oversight and efficient investment decisions of network operators, and decisions made by generators. Retailers do not directly influence either of these cost components. Competition among retailers is a reflection of the efficiency of their risk management strategies and their ability to acquire customers based on these efficiencies.”

As any estimate of a benchmark wholesale energy purchase cost is based upon an assumed risk management strategy and an estimate of the value of the residual risk exposure of the retailer, the potential for material error in the estimate of the wholesale purchase cost exists. Similarly, regulators or governments have needed to make assumptions about efficient retail operating costs when setting the existing retail price controls. The paucity of publicly available data means that little robust analysis has been undertaken into this cost item, again leaving open the potential for material error. The Commission has taken into account the precision of the estimates of margins when deciding how much weight to place upon this source of evidence.

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<sup>321</sup> The Commission engaged CRA to perform this analysis, as discussed further below.

<sup>322</sup> In the electricity market, the spot price for electricity varies materially during each day, from week to week and over longer periods. For this reason, retailers manage their risk by purchasing a range of derivative instruments, including swaps (which set an agreed price for a fixed price for a quantity electricity), caps (which place a cap on the price that is paid for a fixed quantity of electricity, generally set at \$200 or \$300 MWh) and options for purchase these instruments, whose prices also vary materially over time.

<sup>323</sup> Origin Energy, submission to the Issues Paper, p. 14.

### 8.1.2 Estimating average retail profit margins

The Commission engaged CRA to provide independent advice on the profit margins available to retailers and their relationship to the effectiveness of retail competition in Victoria. More specifically this included considering:

- if the margins that are available under the standing offer tariff provide an indication of whether existing retail price regulation is consistent with new entry and competition, or may be affecting the observed degree of rivalry, either generally, for a geographic area or a customer type; and
- where there was scope for competitive entry, if the outturn margins in market offers reflect those that would be expected within a competitive market environment.

The starting point for the CRA analysis was the retail cost estimates used in providing advice to the Victorian Government in 2003 in relation to the current price paths for electricity and gas, which commenced on 1 January 2004.<sup>324</sup> The data and estimates were subsequently updated in order to reflect more current information where appropriate. The approach to estimating the different cost items is as follows:

- **Energy costs** – the cost associated with holding an assumed efficient portfolio of contracts, plus an assumed allowance for the value of the residual spot price risk exposure.<sup>325</sup>
- **Retail operating costs** – were based upon the assumptions that regulators have made in recent decisions on retail price caps.
- **Acquisition costs** – were based upon the average customer acquisition cost reported by retailers in the Retailer Survey, amortised over three years. In addition, a calculation was done to reflect the cost of customer acquisition as a component of business acquisition costs in a trade sale transaction.
- **Network charges** – were based upon the published, regulated network charges.
- **Net margin** – CRA's recommended range for the margin was upon a combination of empirical observation of retailers' margins and the values adopted by regulators in recent retail pricing decisions or advices.
- **Revenue** – for the margin that is available under the standing offer prices, the published tariffs have been used, together with information on the average usage characteristics of customers. For the margin under market offers, a plausible range has been adopted based upon knowledge of actual market offers,

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<sup>324</sup> The basis for this was that the standing offer price levels were based on the assumptions, estimates and projects of cost that were made at the time, plus net margins that the Victorian Government considered to be reasonable.

<sup>325</sup> The Consumer Action Law Centre commented in its submission to the First Draft Report (at p. 10) that the CRA analysis should consider the extent that retailers are currently hedged. In that regard, an efficient portfolio assumes some level of hedging and has therefore been included in the CRA analysis.



expressed as a percentage discount off of the standing offer tariff. The average discount is assumed by CRA to be 5 per cent.

At the time of the First Draft Report, the Commission only had access to preliminary results from CRA. The Commission's examination of the preliminary results suggested that competition appeared to have placed a sufficient discipline on retailers' market offers to limit margins to those expected in a competitive market. Similarly, margins available under the standing offer tariff for electricity did not appear to have prevented efficient new entrants from being profitable at least when considered on average across all customers in a distributor's service area. For gas, however, the results indicated that the scope to offer discounts off standing offer tariffs may have been more limited.

The Commission subsequently received a Final Report from CRA on 8 November 2007<sup>326</sup> and as a result has been able to draw further conclusions about the impact of profit margins on competition in Victoria.

In its Final Report, CRA presented a range of possible margins that included a number of sensitivities related to the number of customers on market contracts, retail operating costs and customer acquisition costs. In addition, CRA considered margins derived from other sources such as annual reports. The Commission considers that a margin that includes an amount for customer acquisition costs for both market offers and standing offers, applied consistently, is most relevant for this analysis.<sup>327</sup>

Under the *standing offer tariffs for electricity*, based on the CRA analysis, the average margins that would be earned across the five distribution areas have generally risen over the period of the current price path. While the margins in any year vary across the years and the five Victorian distribution areas, indicative margins available between 2004 and 2007 appear to have ranged between -1 and 10 per cent.<sup>328</sup> Noting that Australian regulators in competitive electricity retail markets have sought to provide margins of around 4 to 5 per cent<sup>329</sup>, the standing offer margins would appear to have been within, or somewhat above, the range expected in a competitive market for the period.

Under the *standing offer tariffs for gas*, the margins appear to be tighter than for electricity, and possibly negative, although based on the evidence a similar

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<sup>326</sup> CRA International, *Final Report: Impact of Prices and Profit Margins on Energy Retail Competition in Victoria*, 8 November 2007.

<sup>327</sup> The Commission considers it is important to recognise that when purchasing the businesses that the host retailers were also acquiring customers. New retailers entering the market have an option of either organic growth through marketing to customers or, where the opportunity is available, purchasing customers through a trade sale. In either case, a consistent amount for customer acquisition costs should be recognised.

<sup>328</sup> CRA International, *Final Report: Impact of Prices and Profit Margins on Energy Retail Competition in Victoria*, 8 November 2007, Table 24, p. 52.

<sup>329</sup> *Ibid*, Table 18, p. 48. The net margins for Tasmania are excluded on the basis that Tasmania is not yet a fully competitive electricity market.

conclusion can be drawn; namely, that the margins available have generally remained within the range expected in a competitive market.

Under the *market contract offers for electricity*, the estimated margins appear to be generally towards the lower end of the range expected in a competitive market. According to CRA, the range of net margins across the period for all distribution areas is between -3 and 9 per cent.<sup>330</sup> For gas, CRA's results suggests that there may not have been sufficient margin for retailers to offer similar discounts to those available for electricity unless customer acquisition costs and retail operating costs were treated as being shared between the two fuels.

In addition to the margin analysis, CRA also considered recent information on net margins reported by Australian energy retailers. For example, published reports relating to AGL and Origin Energy indicate that between 2005 and 2007 net margins based on EBIT for these companies ranged between 6.7 per cent and 11.4 percent.<sup>331</sup> While these margins relate to the operations of integrated, multi-state companies they provide another point of reference in relation to the likely range for margins in the retail market.

The margin analysis suggests that competition appears to have placed a sufficient discipline on retailers' market offers, limiting margins to those expected in a competitive market when considered on average across all customers in a distributor's service area. In addition, the level of the current standing offer tariffs has not prevented efficient new entrants from operating profitably, at least when considered on average across all customers in a distributor's service area. However, this observation does not imply that the existing standing offer tariffs will continue to provide margins sufficient for entry and viable commercial operation. Some retailers suspended active marketing of retail energy contracts when wholesale prices rose during 2007. It is further noted that the prices for electricity derivative contracts for 2008, 2009 and 2010 have risen substantially in the period since March of this year, reflecting concerns about the effect of the drought on generator availability and hence, the potential for higher future spot prices.

### **8.1.3 Margins under the standing offer tariff across customer segments**

The previous discussion related to the margins that are available when averaged across the customers in each distribution network and across the tariffs available. However, as some customers are more costly to serve than the average customer and the revenue received under some tariffs may be lower than the average, it is possible that while the standing offer tariff has permitted competition for most of the customers, it may foreclose competition for part of the market.

As retailers enter the market, it would be expected that they would first seek to target the most profitable customers available. However, over time it would be expected that the process of competition would place pressure on retailers for margins to converge to efficient levels for all customer and tariff types. It would also

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<sup>330</sup> *Ibid*, Table 24, p. 52.

<sup>331</sup> *Ibid*, Table 25, p. 53.

be expected that the process of competition would lead to prices offered to different customer segments reflecting the cost to the retailer of serving that segment, at least to the extent that differentiation is permitted and administratively feasible.

However, the potential exists for the margins available under the standing offer tariff to vary across customers if the cost to serve varies, but a single tariff is available. Equally, margins will vary across the different standing offer tariffs if the average revenue that is available under the different tariffs does not mirror the average cost that retailers incur. The potential therefore exists for the average margins available under the standing offer tariffs to be sufficient to encourage new entry, but they may be insufficient and possibly foreclose competition for some customers or tariff types.

Based on the Retailer Survey and further interviews with retailers, the Commission is aware of three factors that may cause the margin received from a particular customer to vary from the average, namely where the relevant customer:

- is in a regional or remote location;
- consumes less than the average customer; or
- is on an off-peak tariff.

Turning first to cost differences across locations, a number of retail costs are likely to vary across a distribution area, including the cost of acquiring customers<sup>332</sup>, network charges and loss factors. The Commission's analysis suggests that network losses alone could have a material effect on the margins that are available under the standing offer tariffs in some instances. For example, in the Powercor electricity distribution area, the margin from serving customers in a high transmission loss factor area (i.e. the Mildura region) is estimated to be approximately 2.75 percentage points lower than the average margin and approximately 1.75 percentage points higher for customers in a low transmission loss factor area (i.e. areas close to Melbourne). Distribution losses could increase this range further.<sup>333</sup> In the absence of cost reflective pricing for all customers, a margin that is 2.75 percentage points lower in high transmission loss areas is material for the economics of serving those customers.

Turning to customer consumption, the economics of serving a particular customer can be affected by a customer's level of consumption where the structure of the standing offer tariff is not aligned with the structure of costs incurred. Retailers face both fixed and variable costs to serve a customer. Where a tariff is efficiently structured, retailers will be able to recover those fixed costs which are directly attributable to the customer in the fixed charge and those variable costs which are

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<sup>332</sup> Door-knocking in non-metropolitan areas can be more expensive as a result of the time and cost of sending door-knockers to a region as well as the lower density of potential customers. Against this, however, a number of retailers indicated that often the rate of customers agreeing to market contracts can be higher and that customer loyalty tended to be higher in these regions, which would act to offset the higher cost of marketing.

<sup>333</sup> Powercor's distribution loss factors for each voltage level are divided into long and short feeder regions. Losses on long feeders are approximately 10 per cent, compared to approximately 7 per cent on short feeders.

directly attributable to the customer in the variable charge. Where this is not the case there will be an impact on the profitability of some customers based on their level of consumption.

The Commission's own analysis confirms that the expected retail margin available for small retail customers is impacted by the structure of the standing offer tariff, and therefore the consumption of customers. As indicated earlier, while retailers won't necessarily allocate costs on the same pro-rated share across customers, where this is done due to limitations in developing cost reflective pricing inefficient outcomes will arise.

Lastly, the Commission is aware that the economics of serving customers on off-peak tariffs has been a concern in the past, with the 2004 ESC Review indicating that the profitability of a customer is dependent on the ratio of peak to off-peak energy usage (i.e. with the sales on peak supply making up for shortfall on off-peak supply).<sup>334</sup> In particular, the ESC identified that (small business) tariff D was not profitable for all consumption at a peak:off-peak ratio of less than 30 per cent.

The Commission understands that the reduced profitability of retail supply under the off-peak tariffs stems from the use of a single net system load profile<sup>335</sup> that applies to all customers of a distributor in Victoria. That is, retailers are required to use the same load profile for customers irrespective of whether they have peak or off-peak tariffs. Off-peak tariffs contain a lower price for electricity consumed at off-peak times in order to reflect the lower 'social' cost of the electricity at that time. However, because actual electricity use is not metered (only the cumulative electricity is metered), the marginal cost faced by retailers will be the same irrespective of when the customer actually consumes electricity because retailers are required to purchase electricity on the basis of the net system load profile. The Commission understands the issue with off-peak tariffs can be resolved in a number of ways. Several retailers have commented that the introduction of interval meters would remedy the impact of the net system load profile on the profitability of these customers.<sup>336</sup>

The Commission understands that there has been some rebalancing of these tariffs in recent years to reduce the effect of this problem (for example, raising off-peak tariffs relative to peak tariffs). Submissions from retailers differed on whether there was a further need for a rebalancing of tariffs. For instance, in response to the Commission's preliminary view that there did not appear to be evidence of obstacles to tariff rebalancing, TRUenergy stated that the State Government had maintained

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<sup>334</sup> Essential Services Commission, *Review of the Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity – Background Report*, 2004, p. 80.

<sup>335</sup> The net system load profile converts the meter readings from accumulation meters to 30 minute intervals for settlement in the NEM. The profile is determined on the basis of the pattern of consumption of customers connected to the relevant Local Network Service Provider net of the known load from large consumers and street lighting.

<sup>336</sup> If interval meters were not introduced, an alternative strategy may be to adopt a more sophisticated approach to load profiling in Victoria, namely by adopting a separate load profile for controlled load, as is undertaken in South Australia, NSW and on the Energex network: NEMMCO, *Understanding Load Profiles Published from MSATS*, 2007, p. 5.

strict rebalancing constraints on retailers, whereby some tariffs remain less profitable.<sup>337</sup> Alternatively, Origin stated:<sup>338</sup>

“In Victoria Origin does not believe that this [inability to recover the marginal cost to serve] is a major issue due to the progressive rebalancing of customer tariffs, across the segments, which has occurred over the past few years and which has been facilitated by the form of price regulation that was put in place by the government in Victoria. The Victorian price regulation model has allowed restructuring such that margins (% return on sales) are now relatively stable across customer segments despite variations in consumption patterns.”

The Commission notes that retail price regulation has now been removed for small business customers, including for tariff D.<sup>339</sup> Accordingly, remaining concerns about the cost reflectivity of these tariffs can be addressed in the market offer prices of the retailers.

As noted above, the fact that conceptually margins may vary across customers, or are even negative in some instances, does not imply that those customer segments are necessarily unprofitable to serve and hence that competition is foreclosed. Rather, when assessing whether a particular customer is profitable, an efficient retailer would ensure that the revenue expected from the customer covers at least the additional (or marginal) cost incurred. To the extent that some of the costs that retailers face are fixed in nature, there is no reason for retailers to seek the same rate of contribution to these costs from each customer segment.

This view was supported by the esaa which stated that there is little incentive for retailers to limit market offers as long as the offers are reflective of the underlying costs to serve and that the emergence of mass market retailing means that retention of the maximum number of customers possible is one of the most effective ways for a retailer to maximise its return.<sup>340</sup>

Accordingly, the most relevant question is whether there are customer segments where retailers would not expect to recover the marginal cost of serving those segments. While wholesale energy purchase costs and network charges would be expected to be marginal to additional customers, a substantial portion of retail operating costs are likely to be fixed and hence provide some scope for margins under the standing offer tariff to differ across customer segments before competition is foreclosed. Nevertheless, based on the conceptual analysis provided here and the comments of stakeholders, there is some risk that the standing offer may inhibit the development of competition for some customers.

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<sup>337</sup> TRUenergy, submission to the First Draft Report, p. 3.

<sup>338</sup> Origin Energy, submission to the First Draft Report, p. 3.

<sup>339</sup> See: <http://www.dpi.vic.gov.au/DPI/dpinenergy.nsf/childdocs/-844E6406280EB3D5CA25729D00101732-17C2B9959F6C3D49CA2572B10019FA89?open>

<sup>340</sup> Energy Supply Association of Australia, submission to the First Draft Report, p. 4.

## 8.2 Commission's findings

The margins that energy retailers earn under market offers can provide insight into whether the market is subject to effective competition, as one outcome of effective competition is pressure for prices to converge to cost over time. This implies that observed margins should be consistent with the return for risk and financing costs that would be observed in a competitive market.

The Commission's margin analysis suggests that competition appears to have placed a sufficient discipline on retailers' market offers to limit margins to those expected in a competitive market. Similarly, margins available under the standing offer tariff, for electricity, appear not to have prevented efficient new entrants from being profitable, at least when considered on average across all customers in a distributor's service area. For gas, however, the results indicate that the scope to offer discounts off standing offer tariffs may have been more limited.

The Commission is mindful, however, that a reasonable margin for the average customer does not imply that all customers are profitable under the existing standing offer tariff, given that the cost of serving a customer can vary as a result of location, tariff type or levels of consumption. Accordingly, the Commission considers that, despite some comments to the contrary, there remains some risk that the structure and level of the standing offer tariff is inhibiting the further development of competition. However, the Commission would also like to reinforce the need for caution when interpreting estimates of margins and drawing inferences from them about the effectiveness of competition given the inherent imprecision in the exercise.

## 9 Equitable Access to the Benefits of Competition

### 9.1 Introduction

Energy services are essential for all sectors of the community. Electricity is a derived demand good, in that its essential nature derives from the services it enables, such as space heating, lighting, cooking and refrigeration. Inability to access electricity has implications for the ability of consumers to maintain an acceptable standard of living. In assessing whether competition is effective and, going forward, considering whether retail price regulation should be phased out in Victoria, the Commission has paid particular attention to customers' experience of retail competition. While a majority of customers are likely to have similar experiences regarding the level of competition in the market and the ability to exercise choice, the Commission recognises that there may be certain customers that, due to a range of individual and broader social circumstances, are not able to access the full benefits of competition. Where competition is found to be effective for the majority of consumers, consideration will need to be given to the needs of those customer not receiving the full benefits of retail competition, and whether this is a result of the functioning of the market itself or an aspect of broader social conditions and problems.

The Commission notes Origin Energy's concerns that addressing issues of customer vulnerability risks replicating work undertaken by the Committee of Inquiry into the Financial Hardship of Energy Consumers (Committee of Inquiry), and potentially lies outside both the Commission's terms of reference for the Victorian Review and the bounds of the AEMA.<sup>341</sup> However, the Commission considers that these policy and regulatory arrangements are an integral part of the Victorian retail energy market. The interplay between the experience and circumstances of certain groups of consumers and public and private sector frameworks designed to improve those experiences and alleviate the impact of adverse personal circumstances has a direct bearing on the operation of the competitive market and its delivery of services to customers.

The Victorian Government's policy objectives and framework has been supported in submissions to the Issues Paper and particularly those from consumer groups.<sup>342</sup> The Consumer Utilities Advocacy Centre has pointed to the progress made with regard to consumers suffering temporary or chronic hardship since the 2004 ESC Review, but expressed the view that the current hardship policies should not be altered before their success has been fully assessed.<sup>343</sup>

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<sup>341</sup> Specifically, Origin draws attention to clause 14.11(b) of the AEMA, which states that 'Social welfare and equity objectives will be met through clearly specified and transparently funded State and Territory community service obligations that do not materially impede competition': Origin Energy, submission to the Issues Paper, p. 7.

<sup>342</sup> See, for example, submissions to the Issues Paper from Consumer Action Law Centre (p. 21); Consumer Utilities Advocacy Centre (p. 16); and Energy and Water Ombudsman (Victoria) (p. 18).

<sup>343</sup> Consumer Utilities Advocacy Centre, submission to the Issues Paper, p. 16.

This chapter considers the experience of certain categories of consumer who may not be receiving the full benefits of the competitive market, whether because of the functioning of market itself, or because of their personal circumstances, including matters such as financial hardship, personal disadvantage, credit risk or location.

## 9.2 Customers experiencing financial hardship

Inability to pay for consumption of energy when bills are due, either due to temporary or permanent financial hardship is the principal reason why certain customers are unable to participate effectively in the competitive retail energy market. Financial hardship can result in customers being unable to pay for their energy use, placing them in danger of being disconnected, forgoing other necessities in order to maintain energy supply, or resorting to costly means of raising money to pay energy bills, such as “pay day” loans.

An assessment of the number of Victorian energy customers who are experiencing financial hardship is beyond the scope of this review. However, as the ESC observed in its 2004 report, regardless of what proportion of customers experience energy affordability problems, “it is clear that the energy affordability problem is a significant one”.<sup>344</sup>

Customers that do not pay for their consumption of energy generally fall into two categories – those that have the capacity to pay but choose not to pay for a variety of reasons, and those that are unable to pay due to genuine financial hardship.<sup>345</sup> While it is difficult in practice to distinguish between these two categories of customer, the focus of this section is on the circumstances of customers who are in genuinely difficult financial circumstances.

Financial hardship can be permanent, as in the case of the long term unemployed, such that customers may be unable to pay utility bills on a regular basis: temporary, as a result of a single event or confluence of events that render a consumer unable to pay bills for a limited period; or chronic, whereby a customer experiences recurring, though not constant or necessarily permanent, circumstances of financial hardship. However, these descriptions of the various categories of hardship do not necessarily capture the movement in and out of permanent financial stress, and between chronic and temporary hardship. The Victorian Council of Social Service, in its submission to the Committee of Inquiry, noted that:<sup>346</sup>

“...individuals move in and out of financial stress, subject to a range of external factors (e.g. unanticipated financial crisis through accident, adult-onset health problems, family breakdown, etc; labour market developments; changes in social security arrangements, etc). ‘Temporary financial hardship’ can become ‘chronic’. Rigid definitions invariably fail to accommodate this

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<sup>344</sup> Essential Services Commission, *Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity – Background Report*, June 2004, p. 113.

<sup>345</sup> Energy Retailers Association of Australia, *Vulnerable Customer Position Paper*, submission to the Issues Paper, p. 5. See further submissions by retailers to the Committee of Inquiry.

<sup>346</sup> Victorian Council of Social Service, submission to the Committee of Inquiry, pp. 9-10.



movement and transition. Furthermore, measures such as income thresholds are overly simplistic as they fail to take into account the impact of household type or reasonable cost of living and therefore what can be considered 'reasonable income'."

Origin Energy also commented in a submission to the Committee of Inquiry that interpreting most hardship as temporary tended to impose the responsibility for assisting most customers on retailers, whereas chronic or permanent hardship required intervention and assistance from the Government in order to ensure that these customers have sufficient funds to afford necessities such as energy.<sup>347</sup> Recognising the distinction between chronic, permanent or temporary hardship, and the allocation of responsibility between those best placed to assist is a relevant factor in the development of effective policy responses.

### 9.2.1 Responsibility for addressing financial hardship

Financial hardship amongst energy customers is an aspect of the broader problem of poverty and social disadvantage in Australia. The Committee of Inquiry concluded in 2005 that:<sup>348</sup>

"efforts to assist in energy hardship are typically varied and inherently complex. They require cooperation between each of the four major stakeholders: industry, customers, community organisations and the Government".

The Government Energy Consumer Hardship Policy Statement set out a collaborative approach for assisting customers experiencing hardship and assigned significant responsibilities to retailers.<sup>349</sup> Submissions from all sectors of the market acknowledged the necessity of maintaining protective measures for customers in the competitive market. Retailers pointed to retailer hardship policies that pre-existed the Victorian legislative requirements in support of this view. However, the current hardship policy framework has also been criticised in some submissions for effectively requiring retailers to implement aspects of social policy. The ERAA commented that the development of solutions to financial hardship in the energy market has not kept pace with the transition to a competitive energy market supplied by businesses operating on a commercial basis. As such, "traditional expectations for the management of hardship have shifted the burden for social policy to a very small group in the Australian community, the energy retailers."<sup>350</sup>

The Consumer Utilities Advocacy Centre, in its submission to the Issues Paper, cautioned that any changes to the safety net arrangements "do not simply shift

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<sup>347</sup> Origin Energy, submission to Committee of Inquiry Issues Paper, p. 9.

<sup>348</sup> Committee of Inquiry into the Financial Hardship of Energy Consumers, *Main Report*, 2005, p. 19.

<sup>349</sup> *Government Energy Consumer Hardship Policy Statement*, undated.

<sup>350</sup> Energy Retailers Association of Australia, *Vulnerable Customer Position Paper*, submission to the Issues Paper, p. 6.

responsibility from the retailer to the community sector”.<sup>351</sup> In submissions to the Issues Paper, retailers did not resile from their responsibility, as providers of an essential service, towards customers experiencing hardship but did emphasise the importance of cooperation between all stakeholders. The ERAA, for example, stated:<sup>352</sup>

“it is becoming increasingly clear that a solution cannot be found in one small section of the community. As a result, the ERAA recommends a shared social responsibility between the customer; the energy industry; State and Federal Governments; and the Australian community”.

Notwithstanding the conclusion that competition is effective and serving the interests of most consumers, the Commission recognises that customers experiencing financial hardship need assistance to access essential energy services. However, it is important to clearly distinguish between any failure of competition and issues of hardship and affordability. Prices may be determined by competition but still cause financial hardship for some individuals. Price regulation, which distorts the efficient operation of the market to the detriment of all consumers, is not the appropriate means to deal with financial hardship in relation to energy products. The Commission recognises that establishing the framework and means for the provision of assistance to customers suffering financial hardship is primarily the role of policy and that retailers also have a role to play. In the wake of the 2004 ESC Review and the Committee of Inquiry, the Victorian Government implemented a range of policy measures to address customer hardship and access to essential services. Improving the situation of disadvantaged consumers is, and will continue to be, a shared responsibility between the public and private sectors. Retailers can contribute most effectively through identification of customers experiencing financial hardship, providing and facilitating access to payment plans for those experiencing bill payment difficulties, appropriately managing customer disconnection and reconnection and streaming customers to other support mechanisms.

### **9.3 Other circumstances influencing access to the benefits of a competitive market**

In addition to consumers experiencing financial hardship, other customers may be limited in their capacity to exercise choice and fully access the benefits of a competitive market due to a range of personal circumstances. This may include customers with language or numeracy disadvantages and those with specific medical needs that require uninterrupted energy supply.

As discussed in Chapter 6, the Commission has not found evidence that particular groups of customers are being excluded from the market, or that information is acting as a barrier to switching. Retailers are generally making generic offers to all households and small business customers. Similarly, the availability of information does not generally seem to be a barrier to participation in the market. ESC reports

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<sup>351</sup> Consumer Utilities Advocacy Centre, submission to the Issues Paper, p. 12.

<sup>352</sup> Energy Retailers Association of Australia, submission to the Issues Paper, p. 6.

indicate a high level of compliance with information requirements under the relevant codes and guidelines, and that appropriate remedial action is being taken where compliance is found to be inadequate. However, as discussed in Chapter 5, the consumer survey and a number of submissions indicate that there is room for improvement in the quality of information provision and that there have been some serious complaints regarding the conduct of retailers in this regard and in relation to obtaining informed consent. The capacity to access, understand and make decisions on information about energy products and services and to give informed consent to the terms and conditions of an energy contract can be impaired by a variety of personal circumstances. This may include, for example, disabilities associated with old age, vision or cognitive impairment and literacy and numeracy capabilities.

Consumers with literacy and numeracy difficulties, or from non-English speaking backgrounds (NESB)<sup>353</sup>, while not necessarily suffering financial hardship or physical or cognitive disability, may also have difficulty understanding information about market offers or contract terms and conditions. However, evidence provided to the Committee of Inquiry did not suggest that NESB consumers were over-represented in disadvantaged households, particularly amongst those accessing hardship assistance. Similarly, information available during the Victorian Review has not indicated that NESB consumers may be especially disadvantaged in the competitive energy retail market. However, the Commission does not wish to suggest that difficulties particular consumers may have with English comprehension, particularly in the context of door-to-door selling, is not an important issue for ongoing management by policy makers, regulators and retailers.

There will also be a number of consumers with specific high or constant consumption needs which will need to be catered for in the context of a competitive energy market. For example, customers with medical needs may require an assured energy supply to operate specialist medical equipment or maintain a controlled temperature environment. In these cases the possibility of disconnection would have serious repercussions and special arrangements are needed to ensure these requirements continue to be met.

The Government's hardship policy framework currently provides a number of concessions and grants designed to alleviate the difficulty faced by people in these situations. The Life Support Concession provides eligible customers with 1,880 free kilowatt hours of electricity to assist with energy costs associated with the operation of eligible life support machines. Some 3,199 households claimed the concession in 2005-2006, at an average cost of \$231. The Summer Multiple Sclerosis Concession assists with the costs of electrical cooling for concession card holders who suffer from qualifying medical conditions that require the ability to regulate temperature. The concession provides a 17.5 per cent discount on electricity bills during summer. The average value of the concession for 2005-2006 was just under \$19 per household.<sup>354</sup>

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<sup>353</sup> Noting that it should not be assumed that consumers from non-English speaking backgrounds necessarily experience difficulty with English.

<sup>354</sup> Victorian Government Department of Human Services, *State concessions and hardship programs 2005-2006*, 2007, p. 25.

## 9.4 Customers who may be less attractive to retailers

In an effectively competitive market, there will inevitably be consumers whose particular circumstances or characteristics reduce their attractiveness to retailers. This may be due to the cost or inherent difficulty associated with serving particular customers due to location, usage patterns or credit history, which may be perceived to outweigh the potential revenue gains to be made by a retailer. As a result, these customers may not receive the range of attractive offers that are available to others.

### 9.4.1 Consumers in regional, rural or remote areas

For some consumers in regional and rural areas, the degree of access to the competitive market may be influenced by potentially higher acquisition or service charges. The 2004 ESC Review found that regional customers (including small business customers) in small towns and remote locations are less attractive to retailers and therefore less able to participate in, and benefit from, energy retail competition.<sup>355</sup> While the evidence of offers and the rate of switching in regional and rural areas has increased since then, as noted in Chapter 5, customer location was nominated as relatively important by retailers in surveys and interviews conducted by the Commission. Responses from retailers indicate that this primarily reflects variation in the costs of acquisition and the loss factors associated with electricity supply. As indicated in Chapter 8, while these factors may influence the profitability of a customer, the impact is not such that it would likely foreclose on competition for these customers.

Although the cost of acquiring or serving regional and rural customers is potentially higher, retailers have indicated that a customer would not be refused an offer based on location. Indeed, a number of retailers indicated that often the rate of customers agreeing to market contracts can be higher and that customer loyalty tended to be higher in these regions.

### 9.4.2 Credit risk customers

The 2004 ESC Review found that credit risk customers were less attractive to retailers due to the “probability of bad debts and the debt management response process under the Retail Code.” The ESC also observed that “customer targeting on the basis of credit risk is usually confined to avoiding areas for door-to-door sales”, but that this may only affect a small number of customers.<sup>356</sup> However, as noted in Chapter 5, there is little evidence to suggest that those customers that are more likely to be considered high credit risk have been excluded from the marketing activities of retailers.<sup>357</sup>

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<sup>355</sup> Essential Services Commission, *Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity – Overview Report*, June 2004, p. 46.

<sup>356</sup> Essential Services Commission, *Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity – Background Report*, June 2004, p. 62.

<sup>357</sup> Results of both the Customer Survey and the survey conducted by the Footscray Community Legal Centre (FCLC) suggest that customers in lower socio-economic groups, who are likely to

### 9.4.3 Low volume customers

Low volume customers are also potentially less attractive to retailers due to the reduced ability of retailers to recoup fixed and common costs from smaller consumption volumes. The 2004 ESC Review found there was a tendency for low consumption to be associated with low income and potential credit risk.<sup>358</sup>

The Consumer Advocacy Law Centre commented in its submission to the Issues Paper that there was little evidence of the benefits of competitive marketing being equally distributed across all consumers, with most benefit going to high volume business customers and those in the Melbourne metropolitan area, at the expense of low volume or rural/regional customers.<sup>359</sup> However, the Commission has not received any evidence of systemic avoidance of low volume or low margin customers in sourcing or receiving offers. Retailers acknowledged that while low volume customers may be less attractive their marketing does not seek to exclude such customers.

### 9.4.4 Customers in rental accommodation

Customers in rental accommodation face issues in relation to the impact of contract length and early termination fees. The Tenants Union of Victoria, which is supportive of “the application of competition principles and the establishment of competitive markets as the most effective means of ensuring the welfare of consumers and tenants in particular”<sup>360</sup>, has argued that, despite the presence of some portability in energy contracts, longer term contracts containing termination fees may expose tenants to penalties they are unable to avoid, particularly if they are not in a position to enter into a contract at their new premises.<sup>361</sup>

The Tenants Union of Victoria is of the view that this situation remains unchanged from the 2004 ESC Review, which noted that “some specific classes of customers are more vulnerable because of the structure of contracts offered by retailers”.<sup>362</sup> Contract portability - the ability of a tenant on a 6 or 12 month lease to “roll over” a 2 or 3 year contract with an energy retailer, without being subject to additional fees or charges – is of particular significance for tenants.

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have a lower capacity to pay their energy bill, have not been precluded from the marketing activities of retailers. Results of the Customer Survey suggest that customers with a household income of less than \$25,000 per annum were no less likely than other customers to have been contacted by an electricity retailer: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, Table B, pp. 21-22. Results of the survey by the Footscray Community Legal Centre indicate that a minimum of four different energy retailers had door-knocked residents in housing estates in the inner west region suburbs of Ascot Vale and Braybrook in the 12 months to June 2007: Footscray Community Legal Centre, submission to the Issues Paper, p. 6.

<sup>358</sup> Essential Services Commission, *Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity – Draft Report*, March 2004, p. 64.

<sup>359</sup> Consumer Advocacy Law Centre, submission to the Issues Paper, p. 14.

<sup>360</sup> Tenants Union of Victoria, submission to the Issues Paper, p. 11.

<sup>361</sup> *Ibid.*, p. 12.

<sup>362</sup> Essential Services Commission, *Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity – Background Report*, June 2004 p. 109.

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Embedded or inset customers, specifically those in accommodation such as caravan parks, nursing homes or boarding houses that rely on shared access to energy services or receive energy billing from a landlord or other third party may also be less able to access the benefits of a competitive market, particularly given the frequent correlation between this kind of accommodation and low income levels.<sup>363</sup>

## 9.5 Commission's conclusions

The Commission recognises that although the Victorian retail energy market is effectively competitive for the majority of customers, two groups may not be benefiting fully from the competitive energy market:

- consumers whose personal circumstances, such as chronic, permanent or temporary financial hardship or personal disability, restrict their ability to access the benefits of the competitive market; and
- consumers who may be less attractive to retailers due to factors such as location, credit history or low consumption volumes.

Improving the situation of the first group of consumers in a competitive market will largely require policy-based solutions that address the root causes of issues such as financial hardship or the ability of people with disabilities to participate in the market economy generally. These solutions will require a complex mix of government policy and industry responses, and will rest upon effective collaboration between all relevant sectors.

The Victorian Government has implemented a range of policy measures designed to assist customers experiencing financial hardship and various disabilities, including access to essential service specific grants and mandating that retailers maintain hardship policies and offer payment plans. While these are policy matters outside the remit of the Victorian Review, the Commission notes there may be scope to further improve the effectiveness, targeting and coordination of hardship policies and frameworks. There is no question that retailers have a role and responsibility as the front line contact for customers experiencing hardship, and the continuing requirement for retailers to maintain appropriate hardship policies is fundamental to this role. However, there may be a case for considering whether the scope of the current hardship policy obligations of retailers continues to provide an appropriate balance between the role of government in addressing social policy matters and the role of retailers in identifying and assisting their hardship customers. With regard to the second group, there will be some customers in effectively competitive markets who are less profitable or attractive for various reasons and have reduced choices as a result. Nevertheless, the findings of the Victorian Review indicate that potentially less attractive customers are not being excluded or avoided by retailers, who are predominantly utilising mass market approaches for customer marketing and acquisition. In an effectively competitive market, retailers vying for customers will be driven to tailor products and services to meet the specific requirements of a wider

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<sup>363</sup> See further Energy and Water Ombudsman (Victoria), submission to the First Draft Report, p. 4; and Madeleine Kingston, second submission to the First Draft Report, pp. 46-55, 200.

range of customers, including those that may currently be viewed as more costly or less attractive to serve.

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## **10 Moving Forward**

### **10.1 Second Draft Report**

The publication of the First Final Report concludes the first phase of the Victorian Review; that is, the Commission's assessment of the effectiveness of competition in electricity and gas retailing in Victoria. In light of its finding that competition is effective, the AEMA and the Request for Advice require the Commission to provide advice to the Victorian Government and the MCE on ways to phase out retail price regulation. The Commission's draft advice, which is the subject of the Second Draft Report, will be published on the Commission's website concurrently with the publication of the First Final Report.

In the First Draft Report, the Commission invited interested parties to provide their views in response to preliminary issues that were identified as potentially being relevant to the Second Draft Report; namely, a process that provided for the retention of host retailers' obligations to offer to supply and a period of monitoring and reporting on market contract pricing. Submissions that were made on these and other issues relevant to the Commission's advice on phasing out retail price regulation are canvassed and responded to in the Second Draft Report.

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## A Victorian Energy Retailers

As at 1 December 2007, 27 businesses were licensed to retail electricity and 13 businesses were licensed to retail gas in Victoria. However, not all entities that hold retail licences sell energy to domestic and/or small business customers. As at 1 December 2007, 13 of the Victorian retail electricity licensees were selling to customers consuming less than 160MWh per annum and 7 gas licensees were selling to customers consuming less than 5TJ per annum.<sup>364</sup>

This Appendix will provide a brief description of each of the Victorian retail businesses. Table A.1 shows a summary of the retail electricity and gas licences held by each company that retails in Victoria.

**Table A.1 Electricity and gas retail licences**

Retailer	ACT	NSW	Qld	SA	Tas	Vic
AGL	E + G	E + G	E + G	E + G	–	E + G
Australian Power and Gas	–	E + G	E + G	–	–	E + G
Click Energy	–	–	–	–	–	E
Country Energy	E + G	E + G	E	E	E	E
Jackgreen	E + G	E + G	E	E + G	–	E
Momentum Energy	–	E	E	E + G	–	E
Neighbourhood Energy	–	–	–	–	–	E
Origin Energy	E	E + G	E + G	E + G	–	E + G
Powerdirect	E	E	E	E	–	E
Simply Energy (formerly EA-IPR)	–	–	–	E + G	–	E + G
Red Energy	E	E	E	E	E	E + G
TRUenergy	E + G	E + G	E	E + G	E	E + G
Victoria Electricity	–	E	E	E + G	–	E + G

<sup>364</sup> This figure includes Momentum Energy Pty Ltd, who ceased retailing electricity to domestic customers in Victoria in July 2007 but continues to supply small business customers in the jurisdiction.

## A.1 AGL Energy

AGL Energy was formed in October 2006, as a result of a merger of AGL's infrastructure assets with Alinta and the subsequent separation of AGL Energy. AGL Energy retails gas and electricity in the ACT, New South Wales, South Australia and Queensland and Victoria through its subsidiaries which hold retail licences in those jurisdictions. AGL Sales Pty Ltd is the retail gas and electricity subsidiary in Victoria. AGL Energy is one of the three host retailers for each of the gas and electricity regions that operate in Victoria.

In Victoria, AGL Energy holds 31 per cent of domestic electricity customers (651,077), 24 per cent of small business electricity customers (66,304)<sup>365</sup> and 31 per cent of domestic gas customers (505,435) and 26 per cent of business gas customers (11,361).<sup>366</sup>

AGL Energy owns a number of generation assets throughout Victoria, South Australia and New South Wales, with a total combined capacity of 998.5 MW and has a 32.5 per cent share in the Loy Yang A power station, which has a total capacity of 2,120 MW.

## A.2 Australian Power & Gas

Australian Power & Gas Pty Ltd was founded in July 2006. It is a wholly owned subsidiary of Australian Power & Gas Limited (APG), an Australian publicly listed company. Australian Power & Gas holds licences to retail gas and electricity in Victoria, New South Wales and Queensland.

In July 2007, Australian Power & Gas acquired 15,000 domestic customers (including approximately 11,000 Victorian domestic customers<sup>367</sup>) from Momentum Energy in a trade sale. This purchase brought the number of gas and electricity customer accounts held by Australian Power & Gas nationally to 50,000. Australian Power & Gas has upgraded its forecast customer base to 65,000 accounts by the end of the year.<sup>368</sup>

## A.3 Click Energy

Click Energy Pty Ltd was granted a Victorian electricity retail licence in June 2006 and has focused on interacting with customers electronically as a dedicated online

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<sup>365</sup> Australian Energy Regulator, *State of the Energy Market 2007*, p. 173.

<sup>366</sup> Essential Services Commission, *Energy Retail Business Comparative Performance Report for the 2005-06 Financial Year*, November 2006, p.2.

<sup>367</sup> Essential Services Commission, *Draft Decision: Amendments to Energy Retail Code and Electricity Transfer Code – Retailer of Last Resort and Assignment to Third Party*, p. 6.

<sup>368</sup> Australian Power & Gas, *50,000 customer accounts as Victorian acquisition completed*, ASX/Media Release, 6 August 2007.

energy retailer.<sup>369</sup> Click Energy does not hold a licence to retail gas. Click Energy does not presently operate retail electricity or gas businesses in other jurisdictions.

## **A.4 Country Energy**

Country Energy, formed in July 2001 through the merger of three regional electricity distributors, is owned by the NSW government. Country Energy holds licences to retail gas and electricity in the ACT and New South Wales. Country Energy also holds electricity retail licences in Victoria, Queensland, South Australia and Tasmania. Country Energy does not presently hold a gas retail licence for Victoria. Country Energy owns gas networks in NSW (managed by Country Energy Gas Pty Ltd) and electricity networks in NSW and Qld. As at September 2007, Country Energy has more than 870,000 gas and electricity customers throughout NSW, VIC, QLD, SA and ACT.

## **A.5 Simply Energy (formerly EnergyAustralia)**

The EA-IPR Retail Partnership was a 50/50 partnership formed between EnergyAustralia Pty Ltd and IPower Pty Ltd, a subsidiary of International Power Australia. On 26 May 2007, EnergyAustralia announced that International Power Australia had acquired its remaining shares in the partnership.<sup>370</sup> Effective from 1 August 2007, the name of the partnership changed to Simply Energy. The company retails gas and electricity in Victoria and South Australia.

As at September 2007, Simply Energy held over 400,000 gas and electricity customer accounts in Victoria and South Australia.

International Power Australia, Simply Energy's parent company, owns generators and peaking plants in both Victoria and South Australia.<sup>371</sup> The total generation capacity is 890 MW. IPA also owns a share of the SEA Gas underground pipeline between Iona and Pelican Point.

## **A.6 Jackgreen**

Jackgreen (International) Pty Ltd was launched in 2004 and is a wholly owned subsidiary of Jackgreen Ltd, an Australian owned company which is listed on the Australian Stock Exchange. Jackgreen operates retail electricity businesses in Victoria, Australian Capital Territory, New South Wales, Queensland and South Australia. Jackgreen does not currently retail gas but is licensed to do so in the ACT, NSW and South Australia.

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<sup>369</sup> Essential Services Commission, *Electricity Industry Act 2000 Application for a retail licence: Click Energy Pty Ltd – Notice of Decision*, 21 June 2006.

<sup>370</sup> EnergyAustralia, *EnergyAustralia announces sale of South Australia and Victoria retail operations*, News release, 26 May 2007.

<sup>371</sup> International Power Australia owns the Hazelwood generator in Victoria and the Port Lincoln, Mintaro, Dry Creek and Snuggery peaking units, the Pelican Point generators and the Canunda wind farm in South Australia.

Jackgreen has an environmental focus and every product contains between 10 and 100% electricity that is accredited by GreenPower.

## **A.7 Momentum Energy**

Momentum Energy holds electricity retail licences for Victoria, New South Wales, Queensland and South Australia, however as at March 2007, the company was not actively marketing to small customers in New South Wales or Queensland.<sup>372</sup> The company does not presently supply gas, however, they have a gas retail licence for South Australia.

In July 2007, Momentum Energy Pty Ltd sold its 15,000 domestic customers (including all Victorian domestic customers, accounting for approximately 11,000 customers<sup>373</sup>) to Australian Power and Gas<sup>374</sup> but continues to serve its small and medium enterprise (SME) electricity customers.

## **A.8 Neighbourhood Energy**

Our Neighbourhood Energy Pty Ltd (Neighbourhood Energy) is a community focused retailer licensed to retail electricity in Victoria, which it does under the Neighbourhood Energy trading name. Neighbourhood Energy does not retail gas.

Neighbourhood Energy is a registered fundraiser in Victoria and as such its customers can elect to donate their 'pay-on-time' discount to a charity or community group associated with their Community Partner Program.

## **A.9 Origin Energy**

Origin Energy Limited is an Australasian integrated energy company with interests in gas and oil exploration and production, energy retailing, power generation and utility network management. Origin Energy was de-merged from Boral Limited in February 2000 and separately listed on the Australian Stock Exchange. Origin's Victorian retail energy business, where it is a host retailer for gas and electricity, is conducted pursuant to licences held by its subsidiary companies, Origin Energy Electricity Limited (electricity licensee), Origin Energy Gas Limited and Origin Energy (Vic) Pty Ltd (gas licensees). Origin Energy also retails gas and electricity, through its subsidiaries, in New South Wales, Queensland and South Australia and retails electricity in the Australian Capital Territory. In November 2006, Origin Energy acquired Sun Retail and its 800,000 customers from ENERGEX in Queensland.

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<sup>372</sup> Australian Energy Regulator, *State of the Energy Market 2007*, p. 175.

<sup>373</sup> Essential Services Commission, *Draft Decision: Amendments to Energy Retail Code and Electricity Transfer Code – Retailer of Last Resort and Assignment to Third Party*, p. 6.

<sup>374</sup> Momentum Energy, *Transfer of Momentum Energy's Victorian residential customers to Australian Power & Gas*; press release July 24 2007.

Origin's customers are located primarily in Victoria, South Australia and New South Wales. In Victoria, Origin holds 32 per cent of the domestic electricity customers (660,666) and 38 per cent of the small business electricity customers (104,981).<sup>375</sup> For gas, in Victoria Origin holds 35 per cent of the domestic customers (547,988) and 31 per cent of the business customers (13,656).<sup>376</sup> Origin Energy has interests in 870 MW of generation throughout Australia. Of this total, 250 MW is internally contracted.

## **A.10 Powerdirect**

Powerdirect Pty Ltd, formally Australian Energy Ltd, was sold to the Queensland Government owned Ergon Energy in 2006. As a result of restructuring in the Queensland electricity retail sector Powerdirect was sold by the Queensland Government to AGL Sales Pty Ltd in 2007 and now forms part of the AGL Energy group. Powerdirect is licensed to retail electricity in Victoria, Australian Capital Territory, New South Wales, Queensland, and South Australia. Although Powerdirect's customer base ranges from households to large customers, its focus is on servicing small and medium enterprise customers.

## **A.11 Red Energy**

Red Energy Pty Ltd formally launched its electricity retail business in Victoria on 8 July 2004.<sup>377</sup> Since November 2004, Red Energy has been wholly owned by Snowy Hydro Pty Ltd, a generator operating in the NEM. The company holds a Victorian gas retail licence but does not presently operate a gas retail business. Red Energy is also licensed to retail electricity to residential and/or small business customers in the Australian Capital Territory, New South Wales, Queensland and South Australia. Red Energy is currently an active retailer in both Victoria and South Australia.<sup>378</sup>

## **A.12 TRUenergy**

TRUenergy is a host gas and electricity retailer in Victoria. It is a new integrated business that comprises of what was formally TXU, Yallourn Energy and Auspower. TRUenergy was purchased by CLP Power Asia, which is a subsidiary of the CLP Group in May 2005. Prior to that, TRUenergy was the retail arm of the TXU energy business owned by Singapore Power. Through its subsidiaries, TRUenergy Pty Ltd and TRUenergy Yallourn Pty Ltd, TRUenergy is licensed to retail electricity and gas in Victoria, Australian Capital Territory, New South Wales and South Australia, including residential and business customers in the ACT, NSW and South Australia. TRUenergy also retails electricity in Queensland.

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<sup>375</sup> Australian Energy Regulator, *State of the Energy Market 2007*, p. 175.

<sup>376</sup> Essential Services Commission, *Draft Decision: Amendments to Energy Retail Code and Electricity Transfer Code – Retailer of Last Resort and Assignment to Third Party*, p. 6.

<sup>377</sup> Red Energy, *Red Energy launches in Victoria: New player promises to shake up the energy scene*, News release, 8 July 2004.

<sup>378</sup> Australian Energy Regulator, *State of the Energy Market 2007*, p. 171.

As at 31 December 2006, TRUenergy had a total of 600,000 electricity and 500,000 gas accounts.<sup>379</sup> These customers are primarily located in Victoria where it has 24 per cent of the domestic electricity customers (497,676) and 23 per cent of the small business electricity customers (63,541). TRUenergy also holds 27 per cent of the domestic gas customers (431,364) and 40 per cent of the small business gas customers in Victoria (17,264).<sup>380</sup>

TRUenergy owns a number of generation assets in Victoria and South Australia, with a total generation capacity of 1575 MW and is currently constructing a new generator in NSW, which will have a capacity of 400 MW.

### **A.13 Victoria Electricity**

Victoria Electricity Pty Limited commenced trading in 2004 and has been a wholly owned subsidiary of Infratil Limited since April 2007. Infratil also operates in other states through its subsidiaries South Australia Electricity, New South Wales Electricity and Queensland Electricity. Victoria Electricity and South Australia Electricity are licensed to retail electricity and gas (but South Australia Electricity is actively retailing electricity only). New South Wales Electricity and Queensland Electricity are licensed to retail electricity only in those jurisdictions, though they have not yet commenced operations. As of May 2007, Victoria Energy had 250,000 customers.

Infratil also owns Infratil Energy Australia (IEA), which provides wholesale risk management and energy trading support to Victoria Electricity. IEA owns two power stations in South Australia, with a combined total capacity of almost 70 MW.

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<sup>379</sup> CLP Holdings Limited, *2006 Annual Report*, 2006, p. 83.

<sup>380</sup> Essential Services Commission, *Draft Decision: Amendments to Energy Retail Code and Electricity Transfer Code – Retailer of Last Resort and Assignment to Third Party*, p. 6.



## **B    Concentration Indexes**

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## Concentration Indexes

Concentration indexes measure the number and size distribution of firms supplying (or acquiring) goods and services in a market (or industry)<sup>1</sup>, based on some combination of each firm's market share. Concentration indexes are often used as a relevant descriptive statistic, along with individual firms market shares, for the purpose of competition analysis.

The two most commonly used concentration indexes are the *n firm concentration ratio* (CR<sub>n</sub>) and the *Herfindahl-Hirschman Index* (HHI). The *n firm concentration ratio* measures the sum of the market shares of the *n* largest firms in the market, while the HHI is calculated as the sum of the squared market shares of all firms in the market (sometimes multiplied by 1,000). These two indexes have different properties and convey different information. The CR<sub>n</sub> is easily calculated and only requires information on the market shares of the *n* largest firms. It is invariant to the distribution and unevenness of market shares within the group of *n* firms and does not take account of the number or size distribution of other firms in the market. It simply tells us the aggregate market share of the *n* largest firms. Which particular number of firm (*n*) is most relevant will depend on the particular market circumstances and the questions being investigated. Hence, for example, in the case of retail energy markets that have recently been opened to full competition, it may be particularly relevant to consider the market share and changing market share of pre-existing retailers as compared to new entrants. If there were only three retailers before the market was opened to further competition, it would be particularly relevant to examine the CR<sub>3</sub>.

The HHI, by contrast, is affected by both the number and size distribution of all firms in a market, and its value increases with the unevenness of market shares across firms. In economic theory, the HHI bears a direct relationship to the ability of firms to increase prices above competitive levels in the Cournot model of oligopoly. On the other hand, the Cournot model may not be the most relevant model of competition for any particular market. For example, if the main competition concern is the potential exercise of coordinated market power, this may actually be more likely where firms have relatively even market shares, not where market shares are more uneven, as reflected in the HHI.

Concentration (and market shares) can also be measured in different units, one or more of which may be more relevant in particular circumstances. Specifically, volume or value of sales may be more relevant depending on whether the market is characterised by homogeneous or differentiated products. Shares of capacity rather than sales may also be more relevant in some circumstances, e.g. where some firms have more excess capacity than others or where reserves are running out in a natural resource market and hence shares of sales going forward may be quite different to those at the present time.

Market shares and/or concentration indexes are one factor which is relevant when analysing the extent and nature of competition in a market or likely changes to

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<sup>1</sup> A "market" is generally defined for the purposes of competition analysis as an area of close substitution in demand and/or supply, whereas an industry is generally defined in relation to common inputs or production and/or distribution characteristics. While concentration indexes are used in both contexts, the focus in this note is on market concentration for the purposes of competition analysis.

competition in a market as a consequence of mergers or firm conduct. They are relevant because both the unilateral market power<sup>2</sup> of individual firms and the collective or coordinated market power of a group of firms in a market tends to increase with their market share:

- the unilateral market power of a firm tends to increase with its market share because the capacity of other firms in the market to respond competitively to price rises by increasing output tends to decrease with their market share; and because larger market shares often reflect stronger “brand loyalty” or consumer preferences for the individual firm’s products (and hence lower elasticity of demand, i.e. the extent to which consumers will switch to other suppliers if that firm increases prices); and
- co-ordinated market power tends to increase with market concentration because it tends to be easier to reach and monitor price and output agreements between a smaller number of firms and coordinated prices are less likely to be undercut by competition from rivals.

However, most competition analysts regard concentration as only one relevant factor to consider when analysing the effectiveness of competition or likely changes to competition in a market. The Trade Practices Tribunal set out five factors which it regarded as particularly important:

*“In our view effective competition is a process rather than a situation. Nevertheless, whether firms compete is very much a matter of the structure of the markets in which they operate. The elements of market structure which we would stress as needing to be scanned in any case are these:*

- (1) the number and size distribution of independent sellers, especially the degree of market concentration;*
- (2) the height of barriers to entry, that is the ease with which new firms may enter and secure a viable market;*
- (3) the extent to which the products of the industry are characterized by extreme product differentiation and sales promotion;*
- (4) the character of ‘vertical relationships’ with customers and with suppliers and the extent of vertical integration; and*
- (5) the nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities.*

*Of all these elements of market structure, no doubt the most important is (2), the condition of entry. For it is the ease with which firms may enter which establishes the possibilities of market concentration over time; and it is the threat of the entry of a new firm or a new plant into a market which operates as the ultimate regulator of competitive conduct.”<sup>3</sup>*

Similarly, s.50 of the Trade Practices Act (the Act) contains a non-exhaustive list of nine factors which must be taken into account when determining whether a merger is likely to substantially lessen competition in a market.

Essentially, large individual firm(s) market share and/or a relatively high degree of market concentration are a necessary but not sufficient condition for the exercise of market power. Without a large market share or a relatively small number of firms in a

<sup>2</sup> Market power being the inverse of effective competition.

<sup>3</sup> Re QCMA and Defiance Holdings (1976), ATPR 40-012 at 17,246.

market, it is highly unlikely that a firm or group of firms would be able to exercise market power. Nevertheless, other structural or behavioural characteristics of the market, such as those listed in s.50 of the Act, can mean that even in a relatively concentrated market, competition is effective. Particularly important are the conditions for entry into a market – where there are no substantial barriers to entry, such as regulatory barriers or sunk costs, the threat of potential entry by new competitors can discipline firms pricing and other conduct. Similarly, actual or potential import competition can constrain firm conduct. The demand side of the market is also important. Where consumers have strong brand loyalty or are reluctant to switch supplier for other reasons, such as actual or perceived search and switching costs, competition between suppliers may be limited. On the other hand, where consumers acquire goods and services through a procurement tender, this can create strong incentives for competition between suppliers, even if there are relatively few of them.

The “necessary but not sufficient” nature of concentration in competition analysis is reflected in the role that concentration indexes play in the merger guidelines issued by various competition authorities around the world. Most merger guidelines contain a threshold or thresholds for the merged firm’s market share and/or the overall level of concentration in the market, below which the competition authority will not be concerned about the potential competition implications of a merger. Hence, the Australian Competition and Consumer Commission’s current *Merger Guidelines*<sup>4</sup> contain two thresholds, a CR4 of 75% and merged firm’s market share of at least 15%; or a merged firm market share of 40% if the CR4 is less than 75%. The United States *Horizontal Merger Guidelines* contain a spectrum of HHI “thresholds” which indicate variable levels of likely concern about the potential anti-competitive effects of a merger.<sup>5</sup>

Furthermore, when analysing competition in a market, it is generally important to look at both the level and changes in market shares and concentration over time. If market shares move up and down significantly, this may be indicative of active competition, even between a relatively small number of firms. Where new entry has occurred in a market, it will be important to consider the extent to which entrants have been able to increase their market share and any material barriers to further expansion going forward.

The British energy regulator, Ofgem, in its most recent retail energy market report, has emphasised the importance of looking at both the size and changes in energy retailers market shares, and what those market shares reflect in terms of firm conduct. Where incumbent firms have failed to respond competitively to new entry, by offering improved prices and products, they have tended to lose more market share, whereas those firms which have responded competitively may have retained higher market shares.<sup>6</sup>

Every case must be determined on its own facts and the way in which all of the relevant structural and behavioural characteristics of the market interact.

*Dr Jill Walker*  
Director

<sup>4</sup> ACCC, *Merger Guidelines*, June 1999, paragraph 5.95.

<sup>5</sup> United States Department of Justice, *Horizontal Merger Guidelines*, issued April 1992, revised April 1997, section 1.51.

<sup>6</sup> Office of Gas and Electricity Markets (Ofgem), *Domestic Retail Market Report*, June 2007, Chapter 7.

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## C Market Offers for Domestic and Small Business Customers

### C.1 Market Offers for Domestic Customers

#### Summary of Market Offers Available to Domestic Customers (as at 24 September 2007)

Market Offer	Available Discount from the Standing Offer <sup>1</sup>	Term	Price Discount From Standing Offer	Prompt Payment Discount	Early Termination Fees	Other Price or Non-Price Benefits
<b>First Tier Retailers</b>						
<b>AGL</b>						
AGL Advantage (Electricity Only and Dual Fuel)	0%	3 Years	No	No	\$75	\$50 AGL Voucher (conditions apply) AGL note that customers are entitled to an upfront benefit, usually provided as a credit on the customer's bill.
AGL Freedom 5% (Electricity Only and Dual Fuel)	4%	No term	4% <sup>2</sup>	No	\$0	\$50 AGL Voucher (conditions apply)
<b>Origin Energy</b>						
Origin Single Rate (Electricity Only and Dual Fuel)	0%	No Term	No	No	No	No
Origin Off Peak <sup>3</sup> (Electricity Only and Dual Fuel)	0%	No Term	No	No	No	No
<b>TRUenergy</b>						
TRUenergy Go For More (Electricity Only and Dual Fuel)	6%	3 Years	3% <sup>4</sup>	3%	\$90 in Year 1, \$70 in Year 2, \$50 in Year 3	No
TRUenergy Go Easy (Electricity Only and Dual Fuel)	3%	No	No	3%	No	No
<b>Second Tier Retailers</b>						

<b>Australian Power and Gas</b>						
APG Simplicity Plus <sup>5</sup> (Electricity Only and Dual Fuel)	5%	No Term	No	5%	No	No
APG Saver Plus <sup>5</sup> (Electricity Only and Dual Fuel)	6% Elect 5% Gas <sup>6</sup>	3 Years	2 - 3% <sup>2</sup>	3%	\$60 in Year 1, \$50 in Year 2 and \$40 in Year 3	\$25 Up-Front Rebate
<b>Click</b>						
Click Quick <sup>7</sup>	7 – 9% <sup>8</sup>	No Term	No	5%	No	\$25 in Year 1, \$25 in Year 2 for signing up online
Click Easy <sup>7</sup>	7 – 9% <sup>8</sup>	No Term	No	5%	No	\$25 in Year 1, \$25 in Year 2 for signing up online
<b>Country Energy</b>						
Country Energy Premium and Super Saver	9 - 10%	2 Years	6 - 7%	No	\$95	\$60 on completion of transfer to Country Energy
Country Energy You're 'n Charge <sup>9</sup>	N/A	2 Years	N/A	No	\$95	\$60 on completion of transfer to Country Energy
<b>Simply Energy</b>						
Fixed Energy Offer (Electricity Only and Dual Fuel)	<0% <sup>10</sup>	2 Years	No	No	No	No
<b>Jackgreen</b>						
Jackgreen General Domestic Tariff	5%	No Term	No	5% <sup>11</sup>	No	10% GreenPower
Jackgreen Off-Peak Hot Water	5%	No Term	No	5%	No	10% GreenPower
<b>Powerdirect</b>						
Powerdirect Single Rate <sup>12</sup>	0 – 3%	3 Years	0 – 3% <sup>13</sup>	No	\$48	No
Powerdirect Five Day Two Rate <sup>12</sup>	0%	3 Years	No	No	\$48	No
<b>Victoria Electricity Limited</b>						
VEL Residential Standard <sup>5,14</sup> (Electricity Only and Dual Fuel)	0%	No	No	No	No	No



Source: Offers available as per Product Information Statements on retailer's websites as at 24 September 2007. Product Information Statements could not be found for Neighbourhood Energy or Red Energy. In the case of Red Energy, this was because of an upgrade to the Red Energy website.

Notes: (1) Available discount based only on immediate price discounts, discounts for prompt payment and other fixed monetary benefits that do not require the customer to incur expenditure on other items. Up-front monetary benefits are allocated evenly over the term of the relevant contract. (2) The discount is allocated to the consumption component only, ie, there is no discount applied to the fixed charge. (3) Contract offered as Standard or Dedicated Hot Water (4) Due to the structure of this tariff, the discount can exceed 3% depending on the level of consumption. (5) Contract offered as Peak or Peak and Off-Peak (6) \$25 discount applied to electricity component only (7) Contract offered as Peak or Peak and Off-Peak or Dedicated Off-Peak Load (8) Benefit includes \$25 discount and therefore varies depending on consumption and whether the customer is on a Peak only or Peak/Off-Peak contract (9) Requires a Domestic Time of Use Meter (10) This offer is at a premium to the standing offer, however rates are fixed for the term of the contract. (11) Discount not available on 100% GreenPower (12) Powerdirect note that the product information statements outline a base product only and refer readers to the Powerdirect sales team for products more specific to their needs (13) The rate is structured differently to the standing offer such that the relative discount increases with consumption (14) Victoria Electricity note that the pricing specified on their website is for their default rates only and does not specify any prompt payment discounts or other price or non-price incentives. Fixed term contracts may be available.

## C.2 Market Offers for Small Business Customers

### Summary of Market Offers Available to Small Business Customers (as at 24 September 2007)

Market Offer	Available Discount from the Standing Offer <sup>1</sup>	Term	Price Discount From Standing Offer	Prompt Payment Discount	Early Termination Fees	Other Price or Non-Price Benefits
<b>First Tier Retailers</b>						
<b>AGL</b>						
AGL Tariff E (Electricity Only) <sup>2</sup>	0+%	No Term Specified	0+% <sup>3</sup>	No	No	No
AGL Tariff D (Electricity Only) <sup>2</sup>	2%	No Term Specified	2% <sup>4</sup>	No	No	No
<b>Origin Energy</b>						
Origin Option 1 (Tariff E and D) (Electricity Only) <sup>2</sup>	10%	No Term Specified	10%	No	No	No
<b>TRUenergy</b>						
TRUenergy Business Now (Electricity Only and Dual Fuel)	6%	No Term Specified	3%	3%	No	No
TRUenergy Business Edge (Electricity Only and Dual Fuel)	10%	No Term Specified	10% <sup>5</sup>	No	No	No
<b>Second Tier Retailers</b>						
<b>Click</b>						
Click Business	5 – 6%	3 Years	0%	5%	\$110 (Maximum)	\$25 in Year 1, \$25 in Year 2 for signing up online
<b>Country Energy</b>						
Country Energy You're 'n Charge <sup>6</sup>	7%	2 Years	7%	No	\$95	\$60 on completion of transfer to Country Energy
<b>Powerdirect</b>						

Powerdirect Business Single Rate	0+%	3 Years	0+% <sup>2</sup>	No	\$99	No
Powerdirect Five Day Two Rate	2%	3 Years	2% <sup>3</sup>	No	\$99	No
Victoria Electricity Limited						
VEL Commercial Standard Rate <sup>7</sup> (Electricity Only and Dual Fuel)	0%	No Term Specified	0%	No	No	No

Source: Offers available for small businesses in the Origin (CitiPower) distribution area only as per retailer's websites as at 24 September 2007. At the time the Commission undertook its analysis, information about Red Energy's electricity market offers was unavailable due to an upgrade to the Red Energy website.

Notes: (1) Discounts calculated for annual consumption of 12,000kWh peak consumption for Tariff E and 25,000kWh peak and 15,000 kWh off-peak consumption for Tariff D. Available discount based only on immediate price discounts, discounts for prompt payment and other fixed monetary benefits that do not require the customer to incur expenditure on other items. (2) Information contained on retailer's website is for electricity supply only. It is unclear whether the retailers provide small business customers with dual fuel offers at a discount to the standing offer. (3) Discounts are attached to the variable rate applied to consumption over 1,250kWh per month such that savings from the standing offer become available as consumption increases. (4) Discount of 3% applied to peak variable charge (4) Discount applied to standard business electricity rates, fixed for the first 12 months. It is unclear whether any discount is provided for gas supply. (5) TRUenergy note that conditions apply, although it is unclear what these conditions are. (6) Requires a Business Time of Use Meter (7) Victoria Electricity note that the pricing specified on their website is for their default rates only and does not specify any prompt payment discounts or other price or non-price incentives. Fixed term contracts at fixed rates are available for up to 48 months, subject to certain conditions.

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## D Information Requirements

Energy retailers are required to make information about their market offers available to customers in accordance with both the ESC's *Guideline No. 19: Energy Product Disclosure* (Product Disclosure Guideline) and *Code of Conduct for Marketing Retail Energy in Victoria* (Marketing Code). They are also required to provide specific information to customers on their energy bills in accordance with the Energy Retail Code.

### D.1 Product Disclosure Guideline

In 2004, both the EIA and the GIA were amended to create a deemed licence condition for retailers to publish details of both tariffs and terms and conditions of contracts available to small customers on their internet site. In accordance with these amendments, the ESC published an Energy Product Disclosure guideline in August 2005 after consultation with retailers and other relevant stakeholders.<sup>381</sup>

Under the ESC's Product Disclosure Guideline, all retailers are required to produce and publish on their website a product information statement for each of their market offers, which includes the following:

- all fees and charges separately disclosed, on both a GST exclusive and inclusive basis, including the tariff and early termination fees, if applicable;<sup>382</sup>
- where a different tariff is applicable at different times, when the different tariffs apply;
- details, if applicable, of any rebates (other than government funded rebates), non-price incentives, bill smoothing arrangements and dual fuel arrangements;
- the term of the contract and the termination notification required;
- an explanation of how the tariff and other fees and charges can change, if applicable;
- where the retailer intends to make the tariff or any other element of the published details available only for a fixed period, the availability and end date;
- a complete description of all the characteristics relevant to determining whether the tariff or term or condition is applicable to a customer ("eligibility criteria");
- a disclaimer statement indicating that the information is indicative only and does not include any applicable network tariff rebates or concessions; and

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<sup>381</sup> The guideline was revised in December 2005. See Essential Services Commission, *Guideline No. 19: Energy Product Disclosure*, Issue 2, December 2005.

<sup>382</sup> All fixed fees and charges relating to the supply of energy must be expressed as cents per day and variable fees and charges expressed as cents per kilowatt hour or megajoule.

- a statement which informs and directs the reader to the ESC's website and Energy Comparator for further information.

Retailers are required to update a product information statement within five business days of any change to the information presented in the statement and must provide such statements on request, in writing.

In order to enable customers to access information with relative ease, retailers are required to establish an online process by which customers can easily identify the most relevant product information statement to their circumstances by making a limited number of selections or answering a limited number of questions. Customers should not be required to provide technical or personal information before being able to access one or more product information statements.<sup>383</sup> Where the retailer determines that there is no tariff available for the customer based on the information provided, it must communicate this to the customer. Where more than one tariff may apply, the retailer must either provide a product information statement for one of the potentially applicable tariffs or for each potentially applicable tariff and indicate that it is not clear on the basis of the information provided which product information statement applies.

In addition to product information statements, retailers must also provide an offer summary in writing to a small customer on request and when providing the customer the terms, or information about the terms, of a new retail contract. Such offer summaries must be a separate document to the full contractual terms and conditions and must include the information set out above, excluding the eligibility criteria and disclaimers.<sup>384</sup> Retailers may include more than the minimum information requirements in the offer summaries, although such information should be appropriate and not excessive.

## D.2 Marketing Code

Under the Marketing Code, retailers are required to provide customers with certain information before they enter into a contract, including:

- the type, frequency of bills and payment methods the consumer will receive;
- the details of all applicable prices, charges, tariffs and service levels that will apply to the consumer, inclusive of GST;
- any rights the consumer has to cancel the contract, the charges, if any, that would apply on cancellation and the circumstances where these charges would apply;

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<sup>383</sup> Technical information includes the customer's meter type, consumption, retail tariff, network tariff, distribution area, national metering identifier or meter installation registration number. The ESC notes that it does not intend to prevent retailers from asking customers about these characteristics. Rather, a customer must not be required to provide such information in order to proceed through the online process to obtain a product information statement.

<sup>384</sup> In relation to any fixed fees or charges relating to the supply of energy, the offer summary must also include the number of days in the period to which the charge relates.

- all relevant information about any difference between the contract's terms and conditions and the basic terms and conditions under the Energy Retail Code;
- in the case of contracts formed by door knockers, the full terms of the contract including the period of the contract; and
- whether the marketing representative will receive a commission or fee from the retailer if the customer enters into a contract.

The retailer is required to provide the customer with a reasonable opportunity to consider this information before entering into the contract. After a customer has entered into a contract, retailers are required to send the following information to the customer within two business days, unless already provided:

- the full terms, conditions and applicable costs of the contract including the period of the contract;
- advice to the consumer that they have a right to cancel the contract, and a retailer contact point which the consumer may require for further information, or to cancel the contract;
- government energy assistance schemes which may be available to the consumer;
- how to make a complaint to, or enquiry of, the retailer and details of the Energy and Water Ombudsman (Victoria); and
- the existence and general scope of the Marketing Code and how to access the Marketing Code compliance procedures.

The Marketing Code also requires retailers, among other things, to:

- refrain from engaging in misleading or deceptive conduct, unconscionable conduct or making false or misleading representations;
- ensure that all relevant facts are provided and are not exaggerated, use words and images that promote customer comprehension and use best endeavours to ensure that information provided to consumers is truthful and when supplied directly to individual consumers, relevant to that consumer's circumstances;
- ensure that any comparisons made are clear, factually correct and easily understood by consumers and that they do not omit important information that should be disclosed;
- ensure that the inclusion of rebates and/or concessions is made clear to consumers and any prices that exclude rebates and concessions be disclosed;
- provide specific information to a consumer before they enter into a contract and provide the consumer with a reasonable opportunity to consider this information.

In addition to the obligations around marketing activity, retailers must also obtain explicit informed consent before transferring a customer to a market contract.<sup>385</sup> The ESC considers consent to be explicit and informed where it is given in writing, electronically or verbally, and where the retailer has fully and adequately disclosed, in plain English, all matters relevant to the consent such that the customer was likely to be aware of what the consent applied to.<sup>386</sup> Retailers are required to keep a record of any explicit informed consent given by a customer for at least as long as the retailer has any related contract with the customer.<sup>387</sup>

### D.2.1 Energy Retail Code

In addition to the above, retailers must also include at least the following information in a customer's bill:

- the relevant tariff or tariffs applicable to the customer;
- whether the bill is based on a meter reading or is wholly an estimated bill;
- whether the bill is based on any substituted data;
- the total amount of electricity (in kWh) or of gas (in MJ) or of both consumed in each period in respect of which a relevant tariff applies to the customer;
  - where the customer's meter measures and records consumption data only on an accumulation basis, the bill must include the dates and total amounts of the immediately previous and current meter readings, estimates or substitutes;
  - if the retailer elects to include meter readings or accumulated energy usage from an interval meter on the bill, it must include the meter readings or accumulated energy usage based on quantities read or collected from the corresponding meter accumulation register(s);
- if the retailer directly passes through a network charge to the customer, the separate amount of the network charge;
- the amount payable for electricity and/or gas;
- the amount of arrears or credit and the amount of any refundable advance provided by the customer;

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<sup>385</sup> Essential Services Commission, *Code of Conduct for Marketing Retail Energy in Victoria*, October 2004, clause 7.1, p. 11.

<sup>386</sup> Essential Services Commission, *Guideline No. 10 Confidentiality and Informed Consent Electricity and Gas*, May 2002, clause 5, pp. 8-9. A customer will not be considered capable of giving consent if he or she is not capable of understanding issues, forming views based on reasoned judgement and/or communicating his or her decision. Minors are assumed not to be competent to provide consent unless the retailer can establish that the preconditions to the validity of such a contract are satisfied.

<sup>387</sup> Essential Services Commission, *Guideline No. 10 Confidentiality and Informed Consent Electricity and Gas*, May 2002, clause 6, pp. 9-10.



- a graph showing the customer's energy consumption for the period covered by the bill and, where data is available:
  - the customer's energy consumption for each billing period for the last 12 months; and
  - a comparison of the customer's consumption for the period covered by the bill with the customer's consumption for the same period of the previous year.

This information is designed to allow customers to more easily compare any offers they do receive with their current arrangements.

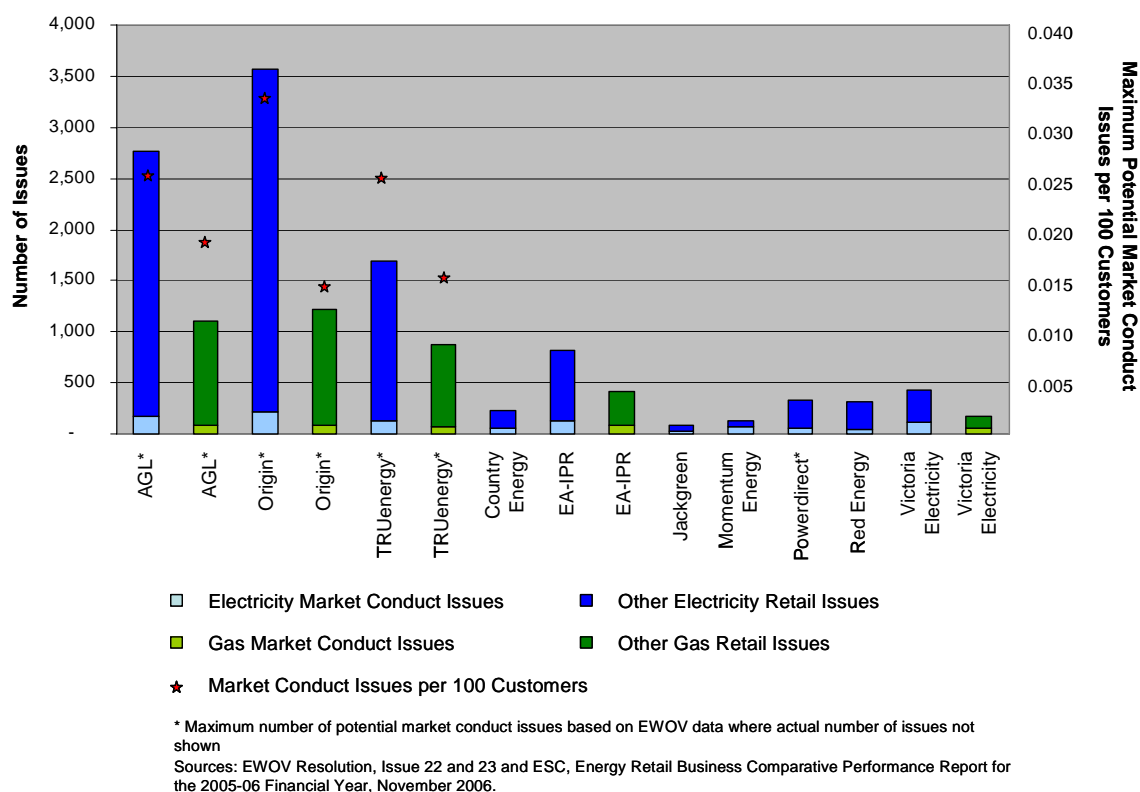
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## E Complaints and Enquiries by Issue

Figure E.1 shows the breakdown of the complaints and enquiries divided into “market conduct issues” and “other retail issues” recorded for each retailer for the 2006 calendar year, and the maximum potential number of market conduct issues per 100 customers for host retailers AGL, Origin Energy and TRUenergy.<sup>388</sup>

EWOV did not publish the number of market conduct issues recorded in relation to AGL, Origin Energy and TRUenergy in issues 22 or 23 of *Resolution* as these cases were not the most common type received for these retailers. Figure E.1 therefore shows the maximum number of market conduct issues that could have been received in relation to these retailers based on the fact that the number of such issues must have been less than the fifth most common issue received.

**Figure E.1 Market conduct and other issues received by EWOV by retailer, year ended 31 December 2006**



<sup>388</sup> The *Resolution* newsletter reports total case numbers for each retailer, as well as the most common issues raised in cases. Multiple issues can be raised in a single case, resulting in more issues than cases reported for each period. A case is an enquiry (a request from a customer for information or a matter that is referred to another agency) or a complaint (an expression of dissatisfaction regarding a policy, practice or customer service performance of a provider that is a participant in the EWOV scheme, where a response or resolution is explicitly or implicitly expected): Energy and Water Ombudsman (Victoria), *2007 Annual Report*, p. 16. EWOV data for issues encompasses all enquiries and complaints and does not explicitly break issues down into these categories, therefore it does not necessarily directly correspond to the number of complaints against retailers. However, the Commission notes that complaints make up approximately 80 per cent of cases.

As shown in Figure E.1, market conduct issues are spread across retailers with no one retailer having more than 300 issues raised in relation to its marketing practices for electricity, gas or dual fuel offers. For the host retailers, the number of market conduct issues per 100 customers was below 0.035 (i.e. the maximum number of market conduct issues raised in relation to any of these retailers was less than 35 per 10,000 customers for both electricity and gas/dual fuel). The Commission does note that while no retailer had more than 300 issues raised against it, the number of issues raised as a proportion of that retailer's customer base does vary between retailers, such that a disproportionately large number of issues have been raised against some retailers. This assessment does not, however, take into account the amount of marketing undertaken by any particular retailer.

The Consumer Survey indicated that approximately two thirds of customers would contact their retailer if they had a reason to complain, and approximately one in three identified EWOF.<sup>389</sup> In light of these results, the number of complaints made to EWOF may not be truly indicative of the extent to which retailers are engaging in high pressure selling or misleading conduct. A better indicator of the extent of such practices may therefore be the number of complaints dealt with by retailers.

Retailers are required to report the number of affordability and other complaints they receive to the ESC as a condition of their licence.<sup>390</sup> The ESC assesses this information and publishes a comparative performance report on an annual basis. Data from the ESC's 2005-06 performance report suggests that the total number of complaints received by each retailer (excluding those in relation to affordability) for the year ended 30 June 2006 ranged from 0.06 per 100 customers for AGL to 16.33 per 100 customers for Jackgreen.<sup>391</sup> Based on the information published by EWOF, only a small proportion of these are likely to be related to market conduct.<sup>392</sup>

For all but three retailers, the number of complaints (excluding affordability complaints) has remained below 0.75 per 100 customers for each of the last five years. Both Momentum and Jackgreen have experienced significantly higher complaint rates than other retailers over the last two years although this is partly due to the fact that these two retailers have a substantially smaller customer base than other retailers. Simply Energy (formerly EA-IPR trading as EnergyAustralia) has also consistently had a higher complaint rate than other retailers, but has shown a dramatic improvement over the year to 30 June 2006, having reduced its complaint rate from 9.63 to 1.79 per 100 customers.

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<sup>389</sup> Only 28 per cent of domestic and 34 per cent of small business customers indicated that they would contact EWOF if they had a reason to make a complaint about their retailer: Wallis Consulting Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets: Consumer Research Report*, October 2007, p. 58.

<sup>390</sup> Essential Services Commission, *Information Specification (Service Performance) for Victorian Energy Retailers*, Decision Paper, June 2005.

<sup>391</sup> Essential Services Commission, *Energy Retail Business Comparative Performance report for the 2005-06 financial year*, November 2006, p. 54.

<sup>392</sup> See Figure 5.1. Those retailers that provided a breakdown of complaints by type in response to the Commission's retailer survey also indicated that market conduct complaints represented only a small proportion of all complaints received.